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EXECUTIVE SUMMARY

The fate of future generations of Georgians will be decided starting now. A girl born in Georgia today can expect to live for more than 86 years, to 2104. This girl, and her peers, will shape Georgia in the 21st century, but her future will also depend on the path that the country chooses today. What will her life look like when she becomes an adult? What will it take for her to be able to realize her dreams in Georgia, rather than abroad? What job prospects will the country offer? How can Georgia become a leading emerging-market economy and middle-class society, in which her children will have even greater opportunities?

This Systematic Country Diagnostic (SCD) highlights the country's core development challenges and opportunities. It takes stock of Georgia's development progress since its "rebirth" a quarter of a century ago. It also takes a forward look at the social and economic landscape, and possible futures that this Georgian girl and her peers will need to navigate. The SCD focuses on the twin goals of ending extreme poverty—which Georgia can achieve in the next decade—and boosting the incomes of households, specifically for those at the bottom of the income distribution, to create shared prosperity. The SCD also lays out the elements of a strategic vision to overcome obstacles and leverage opportunities in sustaining high growth, improving equity, and creating a sustainable future.

A Strong Foundation to Build on

Georgia has experienced tremendous hardship in the early 1990s. After the breakup of the Soviet Union in 1991 and the following civil war, the economy contracted by 65 percent over three years until 1993—an unprecedented economic collapse even among former Soviet Union states. Although a modicum of stability was eventually achieved, the country continued to contend with weak political and economic governance up until the Rose Revolution. Relations with the Russian Federation remained tense, with unresolved territorial conflicts over Abkhazia and South Ossetia, and a large number of internally displaced persons.

But over the past decade, Georgia has done well. The economy has grown robustly at an average annual rate of 4.5 percent. This was despite numerous shocks, including the global financial crisis of 2007-08, the conflict with the Russian Federation in 2008, and the drop in commodity prices since 2014, which impacted key trading partners. Poverty declined from 35 percent in 2006 to 21 percent in 2016. The poor have benefited considerably from the government's social policies, as well as from new economic opportunities. While inequality remains high by regional standards, it has been declining in recent years, with strong welfare improvements among households in the bottom 40 percent of the income distribution.

Deep reforms in economic management and governance have earned Georgia a reputation of “star reformer.” To bolster the private sector, Georgia has introduced rules and regulations that make it easier to do business, and the country’s international ratings on governance and the investment climate have soared. The Deep and Comprehensive Free Trade Area agreement with the European Union (EU) and the proposed Free Trade Area with China are expected to boost trade integration. Energy, tourism, and agribusiness offer strong potential to integrate the country further into the regional and global economy.

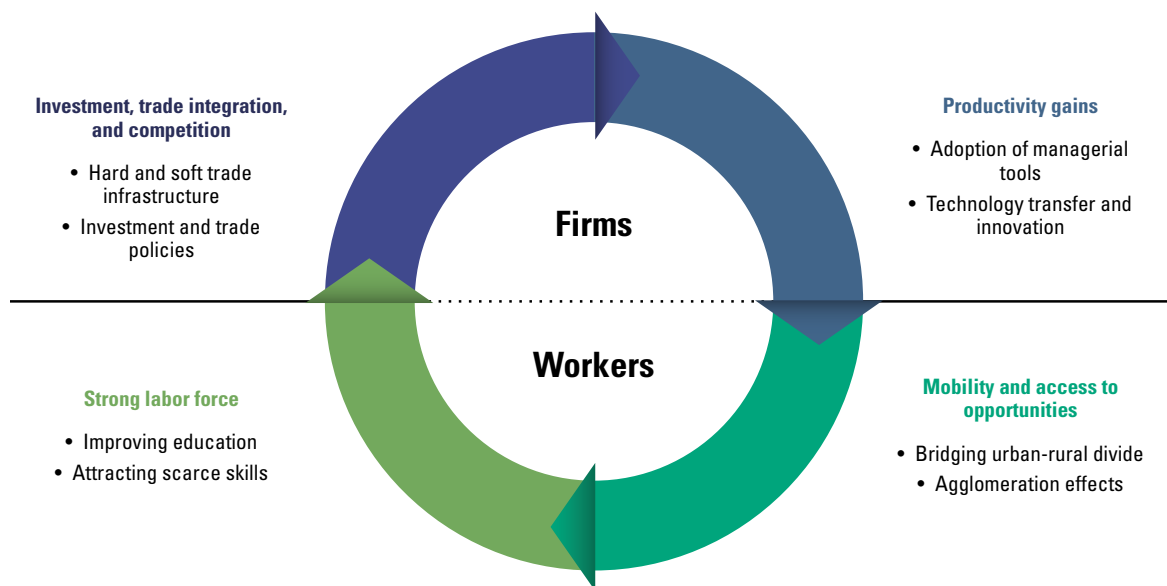
Georgia can begin to dream big. Over the past 25 years, the country has undergone major transformations. Georgia is a fundamentally different and better country today than it was a generation ago. Georgians can be proud of having achieved middle-income status, dramatically reduced extreme poverty to 8 percent, and implemented social policies that support the poorest people and regions. At the same time, the country is still far from the level of broad-based prosperity that EU accession countries now enjoy.

New Challenges – New Vulnerabilities

Georgia faces many new challenges, both internal and external. Its population is shrinking fast due to low fertility and outmigration: it has declined from 5 million in 1991 to 3.7 million today and is projected to fall to just 3 million by 2050. Moreover, it is socially and economically divided between ‘islands’ of rapid progress and a large, mostly rural, hinterland that has not benefited as much from growth and has fewer opportunities. The combination of these trends threatens long-term growth prospects by reducing urbanization and agglomeration opportunities, as well as the skills pool that the country can leverage, and by retaining a large proportion of the population employed in very low productivity activities. Georgia’s small open economy and its specific geography, neighboring the Russian Federation and Turkey, also make it vulnerable to external shocks and regional disturbances, while raising the stakes for export-oriented development.

Social and economic progress has been good, but falls short of expectations, and some gains could be reversed. Georgia’s poverty reduction trajectory

FIGURE ES. 1
A Prosperity Cycle for Georgia



Source: Georgia SCD Team.

has been slower than that of other high performing peers in the region. Despite relatively high rates of economic growth, the pace of poverty reduction has been muted until recently, and it remains overly dependent on pensions and social transfers to a large share of the population that is either unemployed or underemployed. Job creation is weak and women's economic participation and employment rates are lower than men's, impacting the country's income generation and growth. While earned income is the clearest path toward sustainable welfare improvements, formal job creation has been modest; a large share of employment remains in unproductive agriculture and unsophisticated services.

Fiscal and financial sector resilience is being tested. After years of prudent fiscal management, the government has resorted to boosting spending to mitigate the impact of shocks, expand the social safety net, and fill the infrastructure gap. While this course of action may have been warranted, it has resulted in a shrinking of fiscal space that now heightens policy tradeoffs. Moreover, the fiscal outlook is further at risk from large contingent liabilities stemming from public-private partnerships (PPPs), power purchase agreements, and the liabilities of state-owned enterprises (SOEs). Lastly, the banking sector has accumulated systemic vulnerabilities that now exacerbate limited access to finance, while undermining overall macro-financial stability.

The environment is an asset that the country must manage wisely. While Georgia is known internationally for the richness of its culture and nature, the country's environment is under threat, with high levels of indoor and outdoor pollution, illegal logging, and insufficiently controlled exploitation of natural resources. This has adverse impacts on people's health and threatens Georgia's environmental sustainability and its potential as a major tourism destination and a producer of quality agricultural produce.

To Extend Past Progress, Georgia Needs to Shift Gears

The main challenge for Georgia is to continue its past progress. Georgia can double its gross domestic product per capita and eradicate extreme poverty by 2030 if it sustains the average growth rate of the past

10 years of 5 percent. With this growth performance, Georgia will secure its position as an upper-middle-income economy, with an average per capita income of over US\$8,000. Socially, Georgia could transition to become a middle-class society, with more than 80 percent of its citizens above the US\$11-per-day level.

Georgia does not need a new growth paradigm, it needs to adjust and refine its current model.

Indeed, Georgia's robust growth has been based on a growth model with high rates of investment and a significant trade deficit, implying growing debt. Going forward, it will be key for productivity to rise much more sharply. This will require greater integration into the world economy, as well as a fuller and better deployment of the country's human and natural assets. Georgia has already taken steps in this direction and is more integrated into the world economy than a decade ago (for example in tourism). For the next decade, Georgia needs to extend these gains to usher in a new prosperity cycle (figure ES.1).

To enter a new prosperity cycle Georgia will need to continue its path of economic, social, and institutional transformation:

- **Economically, Georgia needs to integrate more effectively with the rest of the world.** Until now, the country has developed large external imbalances, and has not fully leveraged significant foreign direct investment (FDI) to grow its export capacity. It has yet to make the most of its business environment, partly due to a lack of complementary connectivity and skills inputs. To reach the next stage of economic development, Georgia will need to connect with the world economy and develop through exports. This is the only way for a small open economy to create a virtuous circle through which: (i) productivity gains make it attractive to invest in export-oriented production; and (ii) exposure to the global marketplace drives further productivity gains. Given demographic trends and limited fiscal space, there are few alternative options.
- **Socially, Georgia needs to build bridges between those who gain from growth and those who are left out.** Dualism characterizes Georgia's economy and society. While urban households have benefited from economic growth, the rural hinterland has stagnated. The challenge going forward is

twofold, requiring the reinvigoration of the rural economy, while also building bridges between rural and urban areas by investing in people and equalizing access to opportunities for everyone. It is also important to continue efforts to close persistent gender gaps in access to social and economic opportunities, an area in which Georgia has made little progress since the turn of the century. Moreover, to keep the economic momentum going, activation of underemployed Georgians may need to be complemented with immigration (or the return of Georgian expatriates) because fertility will remain too low to stabilize the population and workforce size.

- Institutionally, the challenge is to complete the transition toward a world-class administration. While Georgia has developed islands of governance excellence, all links in the chain need to be strong for the system to deliver. Clean government and a great business environment are necessary but insufficient conditions. A key component is the judicial system. It is also crucial that public service excellence at the top is extended gradually to: (i) local levels of government that play a key role in building bridges between the center and the periphery; and (ii) the management of SOEs.

Leveraging “Brand Georgia”: Pathways and Priorities

The analysis contained in this SCD identifies critical pathways for Georgia to sustain and extend past progress. For Georgia, this does not require reinventing the wheel, but rather transitioning from “reformer to performer,” or ensuring that the significant investments made in building the Georgia brand—accountable government, openness to trade and investment, a pro-business stance—are effectively converted into growth and welfare payoffs.

Supporting Productivity-Driven Growth

To maintain high rates of economic growth, boosting productivity will be key. Long-term growth models point to the core challenge of reigniting productivity growth, given the demographic dynamics and limited scope to dramatically boost domestic savings. This will require a two-pronged approach: addressing cross-cutting factors that constrain productivity for firms in the economy—and deter

investment, particularly FDI—and boosting integration in the global marketplace through greater export orientation.

The country needs to continue improving the environment in which firms operate to attract investment beyond nontradable sectors and backbone infrastructure. This calls for value-chain and sectoral productivity upgrades, including the development of value chains with the potential for growth by providing increased access to finance and markets, both at the value-chain and firm levels. Georgia also needs to address the emerging deficits in skills for the new economy, together with sector-specific bottlenecks in key sectors, such as agriculture, textile, and tourism.

The main horizontal productivity constraints include gaps in transport and information and communication technology (ICT) infrastructure, capacity gaps in public administration, limited access to credit, and skills bottlenecks. Transport connectivity remains weak and it is further undermined by deficiencies in logistics, which raise the cost of trade internally and internationally. Efforts to improve physical connectivity also need to be complemented by further progress in boosting digital adoption, to leverage important investments in expanding ICT’s availability and affordability. Similarly, the dramatic efforts made to improve the quality of the regulatory and institutional environment at the central/top levels needs to be deepened to address significant remaining variability across and within institutions, and particularly at local levels of government. Access to credit remains a constraint, specifically for small and medium enterprises; this calls for action not only to ensure that the banking system remains on a solid footing, but also to decrease the cost of borrowing for firms. Finally, the education system does not produce enough market-relevant skills, particularly soft skills. This calls for broad efforts to leverage significant gains in access to education, through focusing much more on the quality of learning.

Strengthening connectivity to further open up the country to trade, international competition and FDI will be the single most critical driver of efficiency gains. Although the number of exporting firms has increased in recent years, the progression has been slow and most exporting firms remain small, with limited product offerings and low chances of survival. Currently, Georgian would-be exporters are still constrained by significant discovery costs. Attracting FDI, beyond backbone infrastructure and

the financial sector, is therefore a top priority, which calls for enhanced investment policies and possibly targeted incentives. In turn, weaknesses in logistics remain a core bottleneck for effective integration in global value chains. This also includes digital and financial logistics, which play an important role for Georgian firms to become more competitive.

Specific sectors offer significant scope for export-driven expansion, if sector specific constraints to growth and moving up the value chain are addressed. Georgia can leverage initial successes in apparel and tourism. For the former, key priorities include upgrading sector-specific skills and aligning standards to those of key trading partners. For the latter, the main bottlenecks are in the areas of hospitality training, quality standards development and monitoring, and sector-specific infrastructure. Moreover, other tradable sectors also hold significant potential. Agriculture holds significant potential, but it is being held back by production fragmentation, insufficient value chain infrastructure, and limited adherence to core safety and quality standards. In energy, hydro-power development will require efforts to develop cross-border power markets, regulation, and infrastructure, as well as enhanced frameworks for PPPs.

Ensuring Growth Is Inclusive across Social, Demographic, and Spatial Dimensions

With a declining population, Georgia needs to leverage the talents of all its citizens. Given Georgia's unique demographic characteristics and trajectory, and the small and declining size of its labor force, it is imperative for the country to make sure its skills pool is optimally used and deployed. In this respect, and in addition to the focus on skills, two key priorities stand out: maximizing labor force participation and addressing enduring spatial divisions.

Labor force participation needs to increase, especially among women. Too few Georgians are formal wage workers, especially in rural areas and among women and youth. One way of increasing labor force participation is by bringing more women into the labor force, including by expanding the availability and affordability of childcare options. Equally important are policies to activate the youth through tackling sources of labor market exclusion.

Given the demographic dynamics, maintaining the size of the working-age population and closing the skills gap calls for targeted actions to attract

migrants. This could entail efforts to promote the return of the diaspora, as well as to welcome foreign nationals.

Another priority is to build more bridges between the dynamic and lagging areas of the country to bring rural residents into the modern economy. A first step would be to equalize access to opportunities in education and health, including through targeting inequities in service quality, to ensure that the creation and deployment of scarce human capital is maximized. In addition, one needs a better understanding of the types of constraints that impede more fluid spatial mobility from rural to urban areas, as well as economic spillovers from urban growth poles to the rural hinterland. Finally, unleashing the potential of the rural economy, while further developing tourism, would also go a long way in rebalancing opportunities for productive participation in the economy across the country.

Laying the Foundations for Sustainable Growth

Ensuring a sustainable macroeconomic and fiscal framework, as well as environmental protection, are preconditions for the benefits of the policies mentioned above to materialize over time. In the absence of sound macroeconomic and fiscal policies, attracting investment, financing the required infrastructure, and upgrading service delivery will not be possible. Likewise, environmental degradation would undermine a key asset of the country in leading sectors of the economy, namely tourism and agriculture.

Fiscal space is increasingly constrained, calling for additional focus on spending efficiency and sustainability. In recent years, Georgia has relaxed its traditionally prudent fiscal stance, partly for good reasons (expanding social safety nets and responding to crises). The reduced fiscal headroom places additional emphasis on fiscal prudence, enhanced planning, as well as on maximizing the effectiveness of spending—particularly for investment. Another priority is to manage possible existing contingent liabilities, as well as those that may arise in the context of planned PPPs.

Georgia's environment is one of its greatest economic assets, which needs to be nurtured. Currently, however, Georgia has the world's highest mortality rate due to outdoor and indoor air pollution. In addition, unsustainable resource management practices have put stress on the ecosystem,

including illegal logging, cattle grazing and forest fires. Finally, the potential negative environmental impacts of hydropower development need to be managed from the start, through emphasis on impact assessments of projects, coordinated management of water resources and mechanisms for dispute resolution over water usage.

Priorities for a Bright Future

Georgia is on the right track and needs to maintain momentum. Georgia is still making up for the

high losses incurred in the early phase of the post-Soviet transition. But if it continues its reorientation toward an internationally integrated economy with a dynamic labor force, it can become a vibrant hub on the new Silk Road. The country can even overcome the “middle-income trap” by following the example of many EU economies that have reached high-income status since 1990. For this, Georgia needs to stay the course and be ready for the further adjustments that are a normal part of the process of achieving higher levels of income.

BOX ES. 1

Priorities for Georgia: From Reformer to Performer

Top Priority: Unlocking Productivity Growth

Georgia's economy does not have a growth problem per se, but it has accumulated a productivity deficit and depends too much on a small domestic market that is inherently constrained. Thus, to maintain high rates of growth, leveraging trade integration will be paramount.

To unlock the economy's productivity potential, three priorities stand out:

- *Accelerating integration into global value chains*: this is the surest way to overcome information constraints and discovery costs to access external markets, and to address managerial deficiencies that currently limit productivity growth in domestic production.
- *Tackling hard and soft connectivity constraints* to connect Georgia to key markets in the region and beyond.
- *Upgrading skills for the new economy*, because Georgia's workers are still

far from global standards, especially when it comes to the soft skills (ability to learn, leadership, autonomy, languages) that are in highest demand in the new economy.

Unlocking productivity growth is a paramount agenda; without a robust economy that creates jobs, other investments (for example, in social services) will remain underleveraged or become unsustainable.

High Priorities: Addressing Economic Dualism

Georgia's challenging demography is compounded by economic dualism, which means that the pool of talent that the economy can mobilize and leverage through agglomeration effects is shrinking and below potential. In that respect, priorities include:

- *Equalizing access to opportunities and investing in people* to ensure that rural residents can participate in the modern

economy, whether in rural activities or through internal mobility.

- *Modernizing agriculture and leveraging the tourism potential* to raise employment and incomes in the rural economy.

Ensuring Growth Remains Inclusive and Sustainable

For gains to be sustained over time, the economic trajectory of the country needs to remain compatible with fiscal and environmental stability. This will require:

- *Preserving the environment*, because it is both important for the health of the population and constitutes an asset that the country can leverage for growth.
- *Maintaining a sustainable fiscal and financial position* to ensure that the state can continue to provide essential supportive services to the economy and the people of Georgia and retain the ability to respond to shocks.

ABBREVIATIONS

DCFTA	Deep and Comprehensive Free Trade Area	PISA	Program for International Student Assessment
EU	European Union	PPA	power purchase agreement
FDI	foreign direct investment	PPD	public-private dialogue
FTA	free trade agreement	PPP	purchasing power parity or public-private partnership
GDP	gross domestic product	SCD	Systematic Country Diagnostic
GTAP	global trade analysis project	SOE	state-owned enterprise
ICT	information and communication technology	TFP	total factor productivity
IDP	internally displaced person	TSA	targeted social assistance
IHS	Integrated Household Survey	UHC	universal health care
LPI	Logistics Performance Index	UNM	United National Movement
MIC	middle-income country	VAT	value added tax
NBG	National Bank of Georgia	WMS	Welfare Monitoring Survey
NFA	National Food Agency		
NPL	nonperforming loan		

CHAPTER 1

GEORGIA'S TRANSITION – A TURBULENT 25 YEARS

Following a turbulent transition from a Soviet republic to an independent state, the Rose Revolution, and subsequent pro-market reforms, Georgia emerged as one of the top reforming economies in the world in the early 2000s. As a result, Georgians today enjoy a higher standard of living and opportunities for visa-free travel in Europe. In order to maintain high rates of economic growth, Georgia should not shy away from further (and bold) structural reforms and should continue along the path toward further trade integration into international markets.

Findings

- Pro-market and governance reforms, especially on corruption and the tax regime, have propelled Georgia to the top of international rankings on the quality of the business environment, which is unprecedented in the post-Soviet Union space.
- Georgia's economy relies heavily on domestic demand and capital accumulation, while total factor productivity has been declining.

Recommendations

- To maintain past rates of economic growth, Georgia's economic model needs to pivot away from relying solely on domestic consumption and investment, toward greater productivity.



In the 1990s, Rusudan Kekelidze—now the principal of Public School No. 210 in Tbilisi—was a teacher at the start of her professional carrier. She still remembers the smell of kerosene, the grayness everywhere, several students crammed together on a single school desk, and poorly equipped classrooms. There was one common wish shared by everyone back then: to survive. It may sound hard to believe today, but as Rusudan says herself, it truly was a fight for survival in those days, both physically and mentally. It was a fight for the future in the very unstable circumstances of those times. “No matter what skeptics say, a long and difficult path has been travelled since then, thanks to which we can see the development of our schools today. Things are so much better now. You can take the new infrastructure as a vivid example of the change. Or just listen to the phrases you may hear in the hallways, such as I can, I want, I will do, I’m happy to....”

A Rocky Path to Social and Political Normalization

Georgia's post-independence transition has been marked by conflict and upheaval. At independence, the country found itself in disarray, chaos, and conflict. Civil strife, tensions with the Russian Federation, and political instability all exacerbated economic hardships.

- **The political transition was turbulent.** Following the collapse of the Soviet Union, Georgians overwhelmingly voted for independence and elected Zviad Gamsakhurdia as their first president. However, he was overthrown in 1992 by opposition groups led by former Soviet Foreign Minister Eduard Shevardnadze, who went on to remain in office for 11 years. He was eventually ousted in November 2003, following mass demonstrations widely known as the Rose Revolution.
- **Georgia endured periods of civil war and unrest related to the separatist aspirations of Abkhazia and South Ossetia.** Tense relations with the Russian Federation have been further exacerbated by Moscow's support for these separatist regions and recognition of their independence. These flared up into armed conflict in August 2008, which resulted in thousands of additional refugees. Although a cease-fire was negotiated under international pressure, this territorial issue remains unresolved.
- **The economy collapsed and remained weak for a decade.** In the three years following independence, real gross domestic product (GDP) fell by 65 percent. Macroeconomic instability prevailed until the mid-1990s. During 1992–94, inflation averaged nearly 7,000 percent. The situation improved in 1995 with the introduction of a new currency, the elimination of price controls, and a reduction in trade barriers. However, Georgia suffered from the Russian Federation's 1998 economic crisis, as well as stalled reform momentum and rising levels of corruption.

The Rose Revolution opened a new chapter in Georgia's political and economic trajectory. It was brought about by widespread protests over disputed parliamentary elections and culminated in the ouster of President Eduard Shevardnadze, which marked the end of Soviet-era leadership in the country. The Rose Revolution triggered new presidential

and parliamentary elections, which established the United National Movement (UNM) as the dominant ruling party.

In the following years, the country underwent significant governance reforms. The UNM administration inherited an economy in dire straits, an empty treasury and an inefficient administration. The government began by focusing on tax collection and prosecuting high-profile corrupt businessmen and government officials, sending a strong signal that corruption would no longer be tolerated. In parallel, it also began reforms to improve public service delivery, starting with the then ambitious objective of providing continuous power supply to all. Reforms were also implemented in public registries, business regulations, customs, traffic police, and entrance examinations for higher education and local governments.

The results were spectacular. Tax collections increased from 12 percent of GDP in 2003 to 25 percent in 2010 on the back of tax reforms, which included firing corrupt officials, the elimination of tax arrears, a reduction in the number of taxes and tax rates, simplification of the tax code, and the introduction of e-filing of tax returns. Similar reforms were undertaken in other areas, including starting a business and customs, among others. Georgia's performance in international rankings soared. These far-reaching pro-market and governance reforms made the country a leader in the post-Soviet space in terms of the business environment.

Growing dissatisfaction with the UNM eventually led to a political transition, although core developmental and strategic orientations were broadly maintained. The consequences of international conflict and the global financial crisis of 2007–08 created a fertile ground for popular discontent with the UNM. Political opposition was consolidated under the “Georgian Dream – Democratic Georgia” movement, which successfully challenged the ruling UNM and won the election in October 2012.

The Georgia Dream leadership placed greater emphasis on social reforms and inclusive growth. The period during 2012–16 saw increased focus on pro-poor spending and the introduction of universal health care. Nonetheless, stubbornly high unemployment and macroeconomic challenges continued to depress social outcomes.

Georgia has consistently maintained a pro-Western geopolitical orientation and pro-trade policies. In June 2014, the country signed an Association

Agreement with the European Union (EU), which included a Deep and Comprehensive Free Trade Area, and constitutes a first step toward membership in the EU. On February 2, 2017, the European Parliament voted in favor of visa-free travel for Georgian citizens to 26 countries of the Schengen Area and four EU Schengen candidate countries.

Overall, Georgians are optimistic about the future. Opinion polls by the National Democratic Institute show that 72 percent of Georgians believe the country to be in a better place today than 15 years ago, and 69 percent believe that the next generation will also be better off. Institutions, such as the Georgian Orthodox Church, public services, and the army are generally assessed favorably. At the same time, Georgia is not immune from the broader trends of populism and polarization that have swept through the region, which makes it important for the country's leadership to avoid complacency.

Economic Rebirth Following Collapse, but Increasing Signs of Strain

The post-independence collapse was particularly severe. Over a span of four years, GDP per capita contracted almost fourfold, the sharpest decline among all the former Soviet Union states for which data are available.

The speed and pace of the subsequent recovery was also dramatic. In the 20 years between 1997

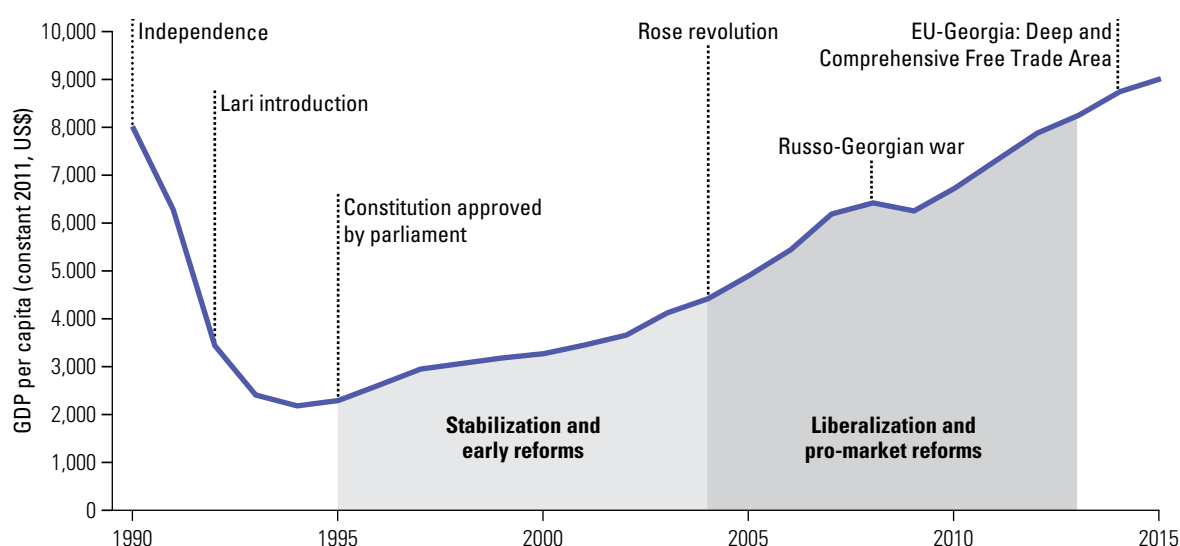
and 2016, the economy grew at a brisk annual average rate of 5.5 percent, below that of resource-rich economies, such as Azerbaijan or Kazakhstan, but faster than in the Russian Federation, Moldova, Estonia, or Ukraine. Thanks to this robust rate of growth, Georgia returned to pre-independence levels of GDP per capita in 2013. Over this period, growth was driven by consumption and high rates of investment with mostly negative contributions from net exports. Far-reaching structural reforms to improve the business environment, liberalize trade, upgrade infrastructure, and strengthen public finances helped to boost average annual growth to 9.3 percent during 2004–07 (figure 1.1). Net foreign direct investment (FDI) inflows (mostly in construction and services) reached 16.5 percent of GDP in 2007. After the economic downturn of 2008–09, a fiscal stimulus and a pickup in external demand helped growth rebound to 5.8 percent annually during 2010–13.

Recently, however, the growth momentum has faltered, mostly due to structural headwinds (figures 1.2 and 1.3). The regional environment has deteriorated since 2014, with the plunge of oil prices, and the economic slowdown in China, both believed to constitute a “new normal” for the region (figure 1.4). Georgia saw a significant weakening in its external performance, stemming from depressed demand in major trading partners, and a loss of competitiveness brought about by relatively larger depreciation in their currencies. Georgia's growth decelerated

FIGURE 1.1

Georgia's 25 Years: Collapse, Stabilization, Acceleration, Crisis, Rebound, and Slowdown

Per capita GDP, 1990–2015

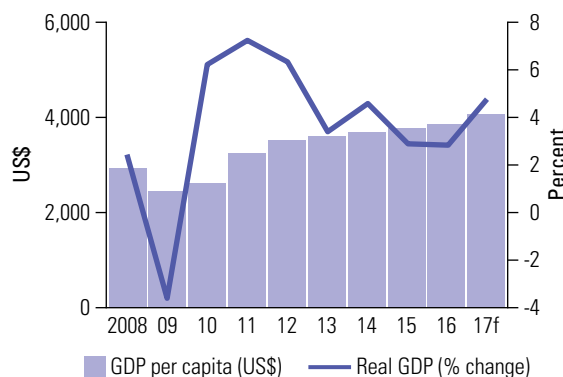


Source: Adapted from World Development Indicators.

FIGURE 1.2

Declining Growth

GDP and Per Capita GDP, 2008–17



Source: World Bank staff calculations based on data from Geostat.

Note: F = forecast.

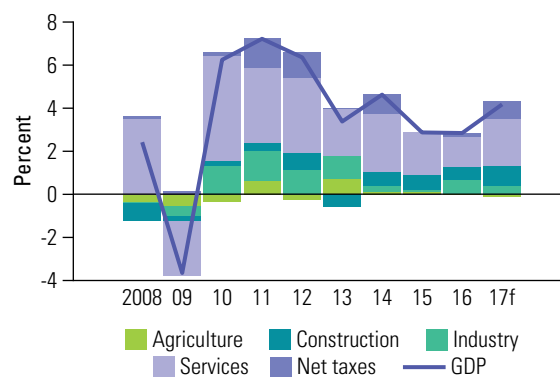
sharply to 2.7 percent in 2016—its weakest performance since the 2008–09 global financial crisis—while total exports fell by 4 percent, after falling by 23 percent in 2015. Remittances—mostly from the Russian Federation and Greece—dropped by 23 percent in U.S. dollar terms in 2015, and recovered by only 5 percent in 2016, depressing private consumption, which fell by 0.3 percent. Preliminary data for 2017 suggest a rebound driven by strong exports and underpinned by regional recovery and fading headwinds. Nonetheless, the recent slowdown has exposed vulnerabilities, which must now be addressed.

The deterioration in the external sector has led to heightened macroeconomic vulnerabilities. The current account deficit widened to 12 percent of GDP in 2015 and then even further to an estimated 12.8 percent in 2016 before improving to estimated 9 percent in 2017 (figure 1.5). Although FDI and official loans remain resilient sources of financing, the large external imbalance generated significant depreciation pressures on the Georgian lari, which lost over 50 percent of its value against the U.S. dollar over 2015–17. Given that public and private debt is largely U.S. dollar-denominated, the Georgian economy is vulnerable. Georgia's public external debt rose to 34 percent of GDP by the end of 2017, up from 27 percent of GDP three years earlier, and total gross external debt (both public and private) rose to 112 percent of GDP by end-September 2017. The banking sector is also exposed to exchange rate risks, as over 60 percent of loans are denominated in U.S. dollars. So far, the ratio of nonperforming loans to total gross loans is low (down from 3.5 percent at the end of 2014 to 2.6 percent at the end of 2017) as

FIGURE 1.3

Strong Domestic Demand

GDP and Drivers of Growth, 2008–17



Source: World Bank staff calculations using data from Geostat.

Note: F = forecast.

the deterioration in asset quality has been contained, supported by sound supervision.

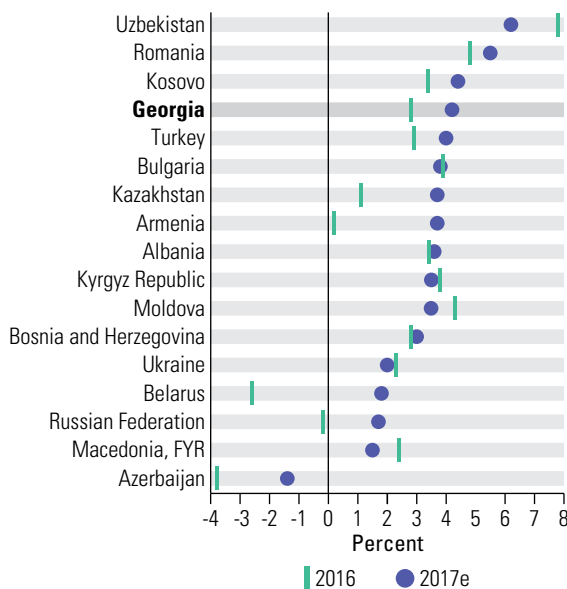
In response to these shocks, the National Bank of Georgia (NBG) largely maintained the flexibility of the lari and raised interest rates to curb inflation. The depreciation of the lari helped to safeguard a modest level of reserves of US\$3.0 billion in December 2017, equivalent to about four months of goods and services imports. Meanwhile, inflationary pressures emerged from the pass-through of the depreciation, and annual inflation accelerated from 1–2 percent in 2014 to 5–6 percent during 2015. In response, the NBG raised its policy rates in increments about once a month, from 4 percent to 8 percent in 2015. As the annual inflation subsided to almost zero toward the end of 2016, the NBG cut the policy rate to 6.50 percent in September. In response to the emerging inflation expectations caused by the recent depreciation and a significant increase in excise taxes on tobacco and fuel for 2017, the inflation remained slightly above the NBG target during most of the 2017 prompting the NBG to increase the refinancing rate by a cumulative 0.75 basis points to 7.25 percent by December 2017.

A budget overrun in 2015 and 2016 raised concerns over the government's fiscal stance. Although the government planned a budget deficit of 3 percent of GDP both for 2015 and 2016, larger-than-envisaged spending led to a widening of the deficit to 3.8 percent of GDP (figure 1.6) in 2015 and further to 4.1 percent of GDP in 2016. Half of the overrun was caused by mounting spending on health and other social benefits (figure 1.7), as beneficiaries started to take up services from the universal health care

FIGURE 1.4

In Europe and Central Asia, Georgia's Growth Is Strong ...

Growth projections, Georgia and comparators, 2016 and 2017



Source: World Bank staff calculations based on data from Geostat.

program. The other half arose from transfers and net lending to state-owned enterprises (SOEs), which more than doubled in 2015.

Emerging fiscal pressures prompted the government to take corrective steps in 2017. The administration that came to power in October 2016 introduced fiscal consolidation measures, which appear to have paid off in 2017. Higher expenditure outlays on social programs and investment were matched with increased tax and nontax revenues (despite the personal income tax reform and thanks to the robust pick-up of growth) and some administrative spending restrictions. Nonetheless, structural pressures on spending remain high. Together with significant contingent liabilities—stemming from public-private partnerships, power purchase agreements, and quasi-fiscal operations of some SOEs—they imply sustainability risks that need to be carefully managed.

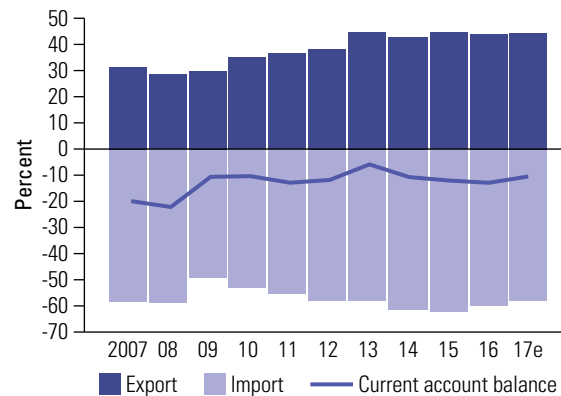
The Georgian Economy Is Still Leaning Too Much on One Engine: Domestic Demand

While structural impediments to growth could be ignored during the boom years, this is no longer true. With the prospect of prolonged regional headwinds, a new focus on sources of long-term productivity gains is required.

FIGURE 1.5

... But the Current Account Deficit Remains Large

Trade and current account deficit, 2007–17



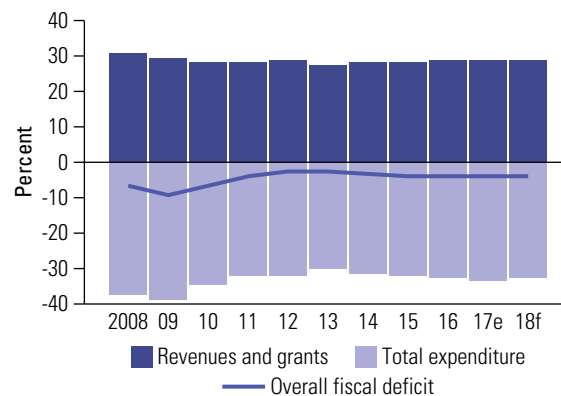
Source: Adapted from the National Bank of Georgia 2017.

Note: E = estimate.

FIGURE 1.6

General Government Revenues, Expenditures, and Fiscal Deficits

Share of GDP, 2008–18



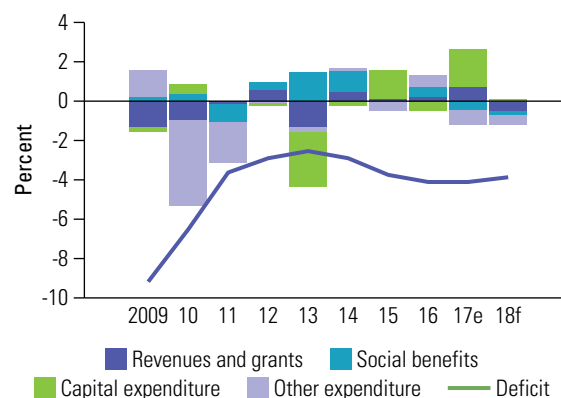
Source: Adapted data from the Georgian Ministry of Finance.

Note: E = estimate and F = forecast

FIGURE 1.7

Drivers of Fiscal Deficit, Change in Fiscal Balances

Share of GDP, 2009–18



Source: Adapted data from the Georgian Ministry of Finance.

Note: E = estimate and F = forecast

The economy remains over reliant on domestic demand. Services account for nearly two-thirds of GDP, but—with the exception of tourism—are mostly made up of nontradable activities, with the highest growth rates in domestic trade, hotels and restaurants, transport and communications, and financial services. Private consumption was supported by higher disposable incomes, but also significant credit growth (figure 1.8).

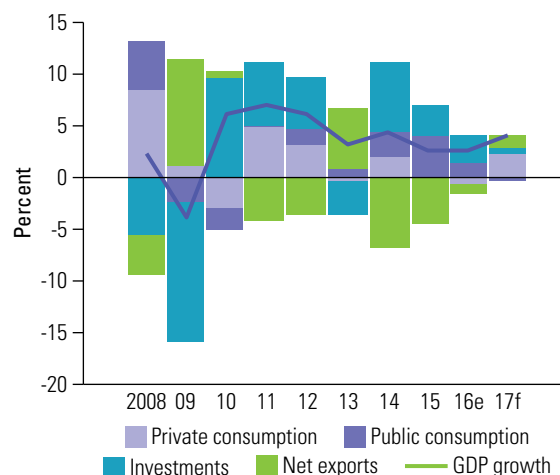
Meanwhile, productivity has declined. Total factor productivity explained most of economic growth during 2004–12, thanks to one-off gains from economic restructuring. But it has fallen since, leaving capital accumulation to play an increasingly important role (figure 1.9).

Georgia is Struggling to Reap the Full Benefits of Pro-Business Reforms

While conditions for doing business are favorable, more dynamic private sector growth is hampered by structural problems. The country has demonstrated stellar progress on business climate reforms. Over the past six years, Georgia has been in the top decile of the Doing Business rankings (figure 1.10). It also has one of the lowest corruption levels in Europe and Central Asia as measured by Transparency International's Corruption Perception Index, and the World Bank's governance indicators (figure 1.11). It is among the top three counties with the most significant improvements over the past 20 years in four out of six dimensions of the World Bank's

FIGURE 1.8

Consumption and Investment Drive Growth, 2008–17



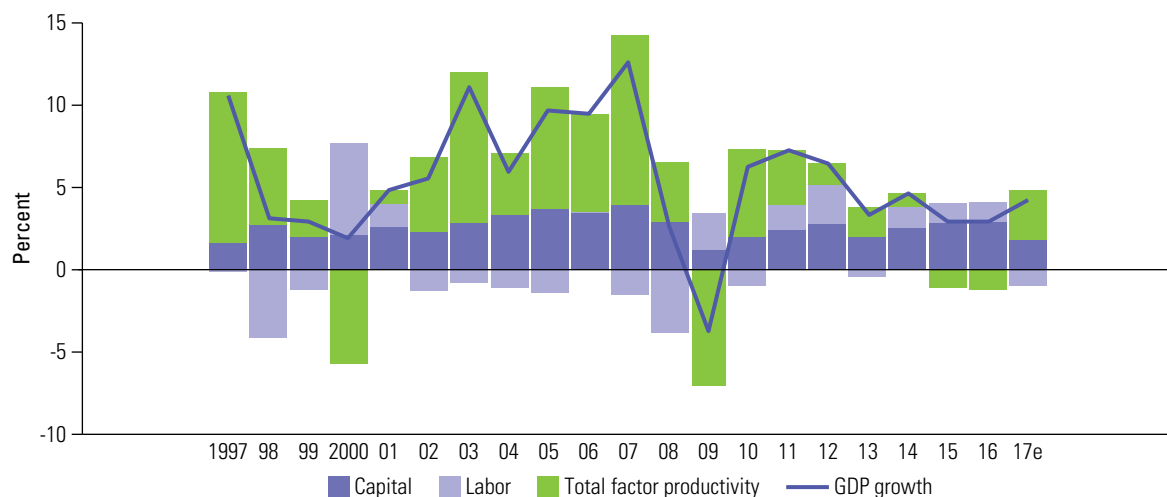
Source: Adapted data from the Georgian Ministry of Finance.

world governance indicators. In regulatory quality, Georgia's rank improved from the bottom 20th percentile to the top 20th percentile. In the other two dimensions, political stability and voice and accountability, Georgia is among the top 15 improvers globally. Finally, Georgia's economy is considered to be among the most liberal in Europe and Central Asia, as demonstrated by the Heritage Foundation's Index of Economic Freedom.

Nonetheless, the country's actual economic performance is not on par with these stellar ratings. Therefore, Georgia needs to focus on understanding what complementary inputs may be required to leverage its solid foundations. Issues include

FIGURE 1.9

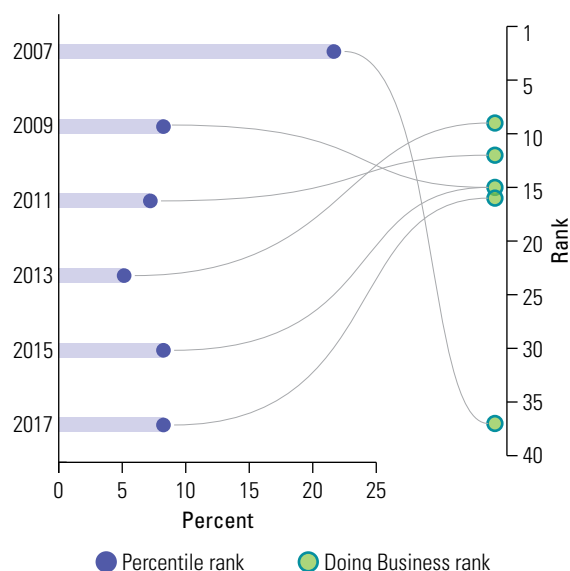
The Contribution of Productivity Has Been Declining, 1997–2017



Source: Adapted data from the Georgian Ministry of Finance.

FIGURE 1.10

Doing Business Ranking, 2007–17



Source: Adapted from World Bank Doing Business data.

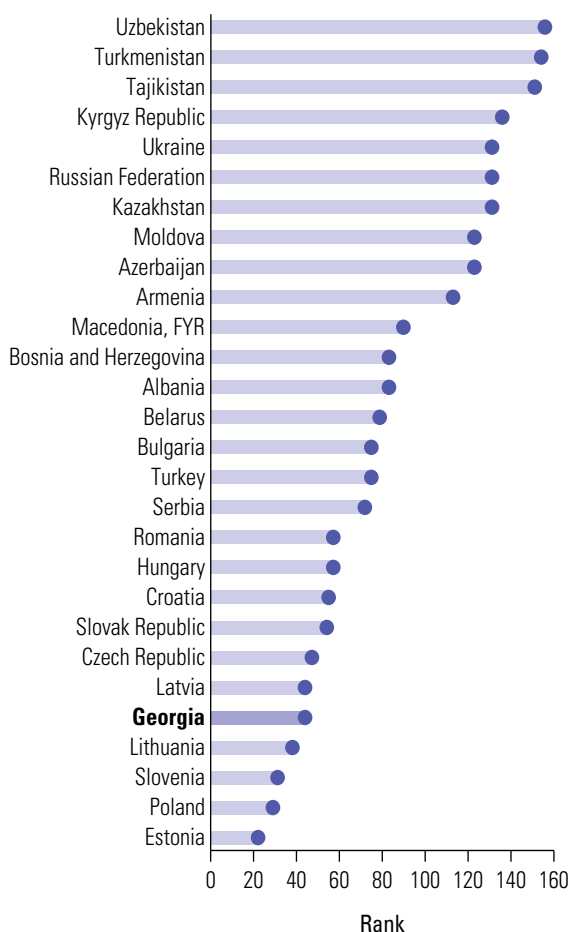
dysfunctional land markets, inadequate firm insolvency frameworks, insufficient financial depth and inclusion, and skills mismatches in the labor market that constrain business growth and investment. These challenges, combined with emerging macro-economic imbalances, remaining institutional inefficiencies, and fluid political dynamics translate into Georgia's low sovereign and corporate credit ratings. Georgia is rated 84th (out of 180 countries) in its institutional investor credit rating and is two notches below investment grade in Moody's, Standard & Poor, and Fitch credit ratings. These factors make investment in Georgia riskier, reducing investor appetite and increasing the cost of capital, ultimately impeding Georgia's deeper integration into the global economy.

Notes

1. World Bank (2012).
2. NDI (2017).
3. Out of total external debt, 30.5 percent is state debt (mostly from international financial institutions on concessional terms), 9.5 percent comes from SOEs, 20 percent from the banking sector, 20 percent from the corporate sector, and 20 percent from intercompany loans.
4. This is calculated following the International Monetary Fund's definition to identify nonperforming loans (NPLs) to be loans over 90 days overdue. Under an alternative more conservative definition used by the National Bank of Georgia, which accounts loans over 30 days overdue as NPLs, the NPL to total gross loans ratio

FIGURE 1.11

Corruption Perception Index Rankings



Source: Adapted from Transparency International Corruption Perception Index.

rose from 7.6 percent in the end of 2014 to 8.1 percent by the third quarter of 2016.

5. Or potentially tradable, yet nontraded
6. Household debt accounts for 27 percent of GDP and 180 percent of households' disposable income.
7. While factoring in human capital in the growth decomposition may modify the picture somewhat, possibly resulting in a higher total factor productivity residual, it would probably not change the overall dynamic of slowing productivity growth.
8. Control of corruption, rule of law, regulatory quality, and government effectiveness.

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CHAPTER 2

PROGRESS ON POVERTY AND SHARED PROSPERITY

Over the past seven years, Georgia has achieved impressive results in lifting people out of poverty, as well as improving their overall well-being. Earned wages, pensions, and social assistance have played a key role in increasing household incomes and, because these gains have been well distributed, they have reduced inequality. However, many Georgians still remain precariously close to the poverty line. To move these vulnerable groups more comfortably into the middle class, future growth will need to generate more productive employment, while access to quality education will need to be equalized so all can participate productively in the economy.



Findings

- While the poverty rate has declined sharply to 4 percent by the international US\$1.90 benchmark, the national poverty line indicates that one in five Georgians is still living in poverty.
- Half of the population is considered vulnerable to falling into poverty, while inequality persists across regions and between rural and urban populations.
- Growth has not benefited the poor as much as it should have because it was not accompanied by robust job creation.



Recommendations

- Address structural bottlenecks in the labor market and the educational system that are preventing large segments of the population from participating in productive employment.
- Bridge existing gender, regional, urban-rural divides in terms of access to opportunities, and improve mobility to optimize the mobilization of talent.



Manana is a stay-at-home mother of seven children aged between 9 and 22. Her husband, Tamaz, spends most of his time at the landfill hunting for scrap metal, and is the sole breadwinner in the family of ten. The family also cares for an elderly grandmother who lives with them in a three-room cinder block hut with a leaky roof and cardboard for windows.

Manana considers herself to be living on the edge of extreme poverty, but she still believes there are households that are far worse off than hers and, regardless of the difficulties, she is proud of her choice to have so many children. "They wear each other's hand-me-downs, and it's a lot of work, but I love kids. I always wanted to have as many as we could. There are large families that live in train wagons, or don't even have a roof over their heads. There are people much worse off."

Manana believes that the priority in tackling poverty should be equal access to education. "When someone with no ability can still get into a school just because they can pay, and when my child, who is talented, cannot just because we don't have money, that's wrong. They are trading talent for money and I don't want that to happen in our country anymore. My 14-year-old daughter Iro is great at table tennis, but we can't afford to equip her or pay for lessons regularly."

Monthly social assistance to the family received from the state amounts to GEL 500 in total, which Manana claims is barely enough to buy shoes for all seven children, not to mention other mandatory items for school that do not fall under the assistance program. Having an illegal job and running the risk of losing social assistance for the entire family does not seem to be the correct or most promising way of fighting poverty. Nonetheless, Manana is doing her best to stay positive and optimistic about her only dream: one day having enough space for all of her children in a house with dry walls and a watertight roof that will help her to keep the children warm and healthy.

Poverty Has Fallen, Especially after 2010

The country has made steady progress in reducing poverty, mostly since 2010. Poverty decreased by more than 15 percentage points between 2010 and 2015, implying that a net cumulative total of more than 550,000 Georgians escaped poverty during this period. This recent success stands in contrast to 2006–10, when the country failed to make any meaningful dent in poverty, as modest gains were largely wiped-out by the twin shocks of the conflict with the Russian Federation in 2008 and the impact of the global financial crisis after 2007–08 (figure 2.1).

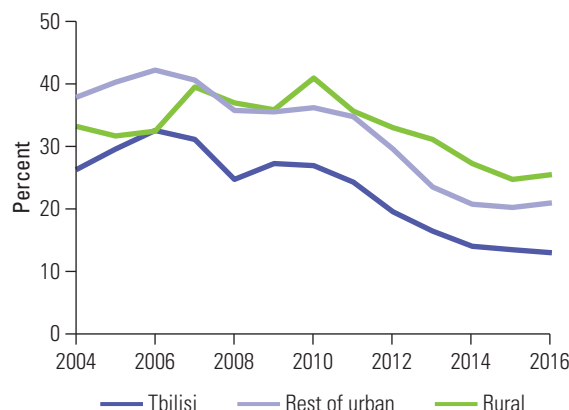
Both urban and rural areas have benefited, although rural areas still lag behind. Since 2010, the trend of poverty reduction has been shared across urban and rural areas, but the latter still face higher poverty incidence: in rural areas poverty stands at 25.5 percent, while it is roughly 17 percent in cities. The post-2010 dynamics contrast to pre-2010 trends, when poverty decreased at a slower pace in cities (after increasing in 2004–06), while increasing in rural areas, peaking at 40.9 percent in 2010, based on the national poverty line (figure 2.2).

Households headed by males benefited more from poverty reduction than those headed by women (who represent about 26 percent of households in 2015). Poverty for male-headed households decreased from roughly 35 percent to 20 percent, while for female-headed households the decline was from 38 percent to 24 percent—smaller in absolute and relative terms. This pattern is present in both urban and rural areas (box 2.1).

FIGURE 2.2

Urban and Rural Areas Have Benefited from Poverty Reduction since 2010, Although Differences Persist

Absolute poverty by location, 2004–16

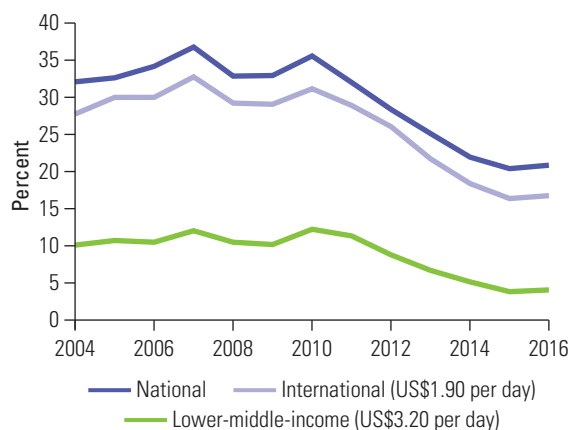


Source: World Bank staff calculations based on data from the IHS database (Geostat).

FIGURE 2.1

Poverty Headcount Using Three Measures of Poverty

National, international, and lower middle-income countries' poverty lines, PPP, 2004–16



Source: World Bank staff calculations based on data from the IHS database (Geostat) and Europe and Central Asia Team for Statistical Development.
Note: PPP = purchasing power parity, 2011 prices.

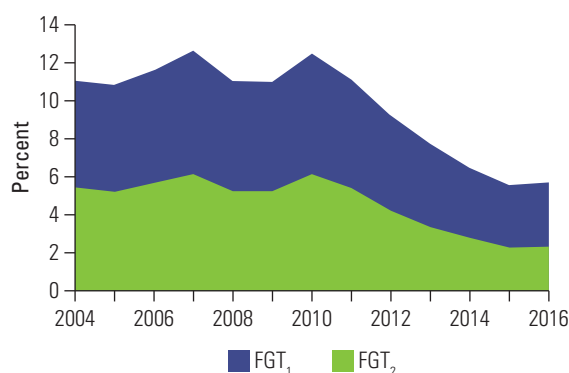
Improvements have also been noteworthy for those still living below the poverty line. The poverty gap index, which is sensitive to both the headcount and the distance from the poverty line for households living in poverty, declined from 12.5 percent of the poverty line in 2010 to 6.0 percent in 2016. The severity of poverty index, which places a greater weight on households furthest from the poverty line, also improved (figure 2.3).

Georgia has also done well on non-income dimensions of well-being. Infant mortality fell from close to 30 per 1,000 live births in 2000 to about 10 per 1,000 live births in 2015. Life expectancy at birth

FIGURE 2.3

Households below the Poverty Line Have Also Benefited, as the Depth and Severity of Poverty Declined since 2010

FGT poverty measures, 2004–16



Source: World Bank staff calculations based on data from the IHS database (Geostat).
Note: FGT = Foster-Greer-Thorbecke.

BOX 2.1

What Do We Know about Poverty and Gender in Georgia?

Poverty rates vary depending on household composition, location and the ability of its members to generate an income. In Georgia, female-headed households account for less than one-third of all households. Half of them report not having a labor income earner in the household, which only happens in one third of male-headed households.

When looking at the earner compositions of households, focusing on differences by gender and labor income, the highest poverty rates are for households with no labor income earners, which represent 32 percent of households. These are households that rely largely on agricultural income, pensions, and social

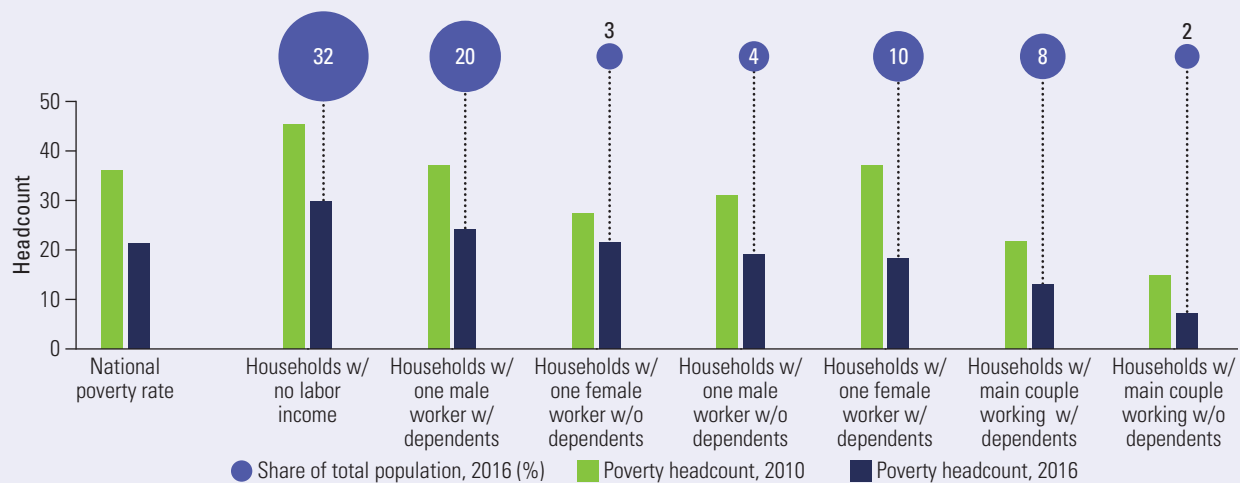
assistance (figure B2.1). One third of these households without earners is headed by a woman—on average, an elderly woman, and another one-third comprises traditional nuclear households of married adult couples with children.

Of the households with a single earner, those with a sole male earner also have poverty rates above the national poverty levels, and are more likely to have, in addition to dependents, another adult in the household who is not working for pay (for example, a spouse). These households, as most households with dependents, are more reliant on nonlabor income than other households, as labor income represents a lower share of the total household

income. For households dependent on a sole female earner, their poverty rates are at the same level or lower than the national poverty rate, particularly those with dependents. Among households that depend on the labor income of a single earner, more than two-thirds depend on a male earner, a share that is higher among the poor. Households where both spouses earn a labor income are the least likely to be poor when compared with other households when only one spouse works, more so when including dependents. Poverty levels in 2010 were higher across all categories described, but the ranking was roughly similar when considering the number of earners in the household.

FIGURE B2.1

Poverty headcount, by household characteristics, 2010 and 2016



Source: World Bank staff calculations based on data from the IHS database (Geostat).

Note: A dependent is defined as an individual younger than 18 or older than 65. An earner is defined as an individual having labor income different from zero in the past year.

increased from 70 in the mid-1990s to 72.7 in 2016. Literacy is almost universal among adults and some 98 percent of children aged 6 to 15 are enrolled in school. Tertiary education enrolment, which dipped briefly after the introduction of reforms requiring the accreditation of educational institutions, has recovered to pre-reform levels, and stood at 43 percent in 2015. Access to electricity and an improved drinking water source is now nearly universal. The share of dwellings with some form of heating system increased from 19 percent in 2006 to 34 percent in 2015.

However, internally displaced persons (IDPs) and the Azerbaijani minority have poorer living standards than the rest of the population. At 7 percent of the population, Georgia has one of the highest shares of IDPs in the world. Apart from the political and economic implications of the unresolved conflicts that spawn them, the country also faces the burden of ensuring sustainable housing and livelihoods for an IDP population that is still largely dependent on social transfers. At present, under 40 percent of IDPs own their own homes and about 22 percent live in new buildings and cottage settlements.

However, 38 percent still inhabit collective centers (hotels or public buildings where they were given shelter pending resettlement). While some collective centers have been rehabilitated, living conditions in most of these are substandard and overcrowded. As a result, the overall poverty rate among IDPs is higher than in the general population, especially in urban areas, where families with an IDP have a poverty rate 3 percentage points higher than the urban average. In addition to IDPs, the Azerbaijani minority that is concentrated in certain regions in the south and southeast of the country has lower living standards and worse access to services than the general population. Among Azerbaijani households the poverty rate stands at 37 percent, well above the national average of 21 percent.

High out-of-pocket expenditures on health are keeping many Georgians in poverty. Universal health care (UHC) was adopted in 2013 to address high out-of-pocket spending for health, which was estimated to be keeping as many as 9 percent of Georgians in poverty in 2010. However, the expansion of UHC did not succeed in easing this burden for households: based on the 2015 household budget survey, there was no significant decline in the share of households that incur impoverishing effects of out-of-pocket expenditures (figures 2.4 and 2.5).

Georgia needs to increase its investments in the health sector to improve population health, reduce the financial burden on households, and ensure the productivity of its human capital. Public health spending has risen sharply with UHC implementation (from 4.0 percent of total government spending

in 2012 to 8.4 percent in 2015), but the current ratio remains below the Europe and Central Asia region middle-income country average of 10.5 percent.

At the same time, there are deeper, longer-term structural problems in the health sector that are a concern for sustainability. The current health system is poorly adapted to dealing with the growing burden of chronic diseases efficiently and cost-effectively. The structure of the current system and incentives embedded in it are a major driver of costs. This includes poor access to good quality primary care services, and the lack of strategic purchasing capacity to effectively control costs. The service delivery system needs a transformation, which would shift service delivery from expensive hospital care to more cost-effective and equitable primary care services. Finally, the challenge of continuing, and possibly expanding, UHC coverage to provide the desired financial protection for the population in a tight fiscal environment has become increasingly binding.

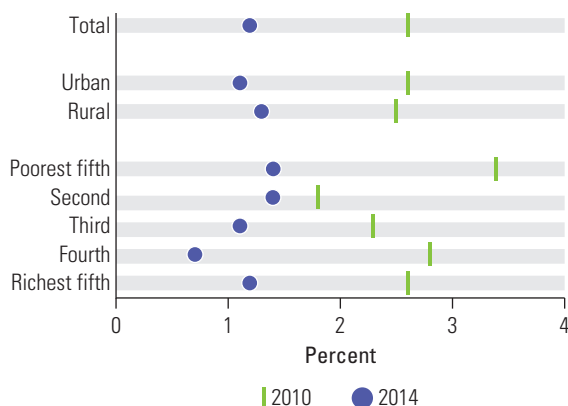
Prosperity Has Been Broadly Shared, Contributing to a Reduction in Inequality

There have been significant improvements in the welfare of the bottom 40 percent, particularly since 2010. The consumption of households in the bottom 40 percent of the income distribution (in both urban and rural areas) grew faster than that of the entire population between 2010 and 2015. This was in sharp contrast to the period 2006–10, when the bottom 40 percent were particularly hard hit (figure 2.6). This puts Georgia's shared prosperity performance on par

FIGURE 2.4

Share of People Who Reported Needing Hospitalization but Not Hospitalized Due to Cost

2010 and 2014

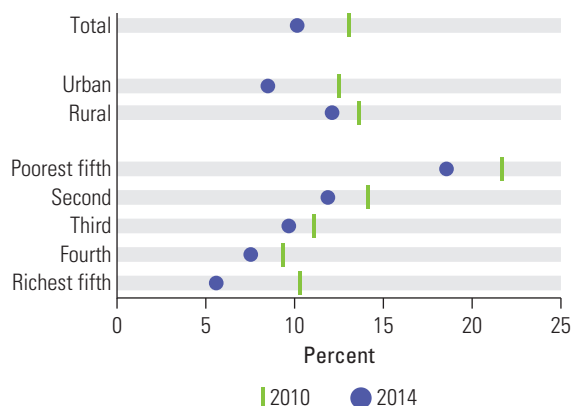


Source: Adapted from the IHS database (Geostat).

FIGURE 2.5

Share of Consultations Where Medicine Was Prescribed but Not Purchased Due to Cost

2010 and 2014

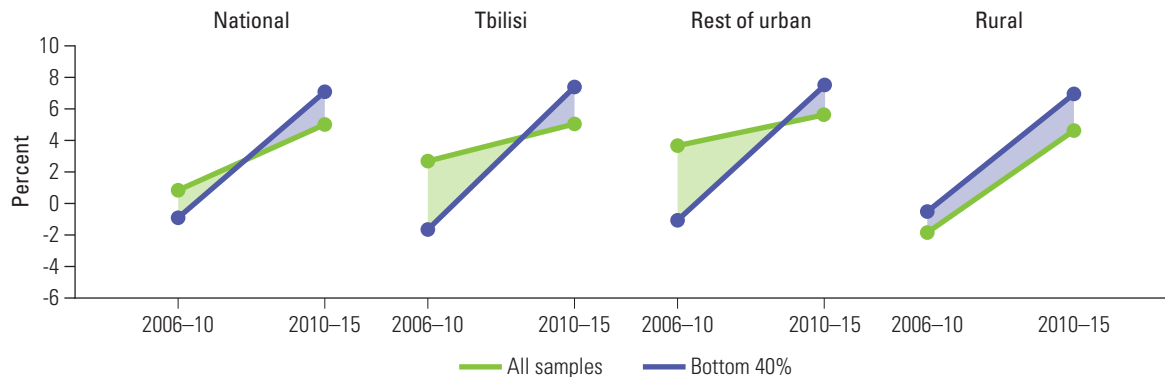


Source: Adapted from the IHS database (Geostat).

FIGURE 2.6

Shared Prosperity Improved across All Locations

Household consumption per capita, annualized growth, 2006–15 (% per capita)



Source: World Bank staff calculations based on data from the IHS database (Geostat).

Note: Data refer to household consumption per capita, annualized growth.

with that of Kazakhstan in 2009–13 and the Russian Federation in 2007–12, when both countries performed particularly well.

Although income inequality has declined in recent years, it is still high. Although inequality declined after 2010, the consumption Gini coefficient still stood at 36.6 percent in 2016 (when measured over the aggregate used for international poverty measurement) making Georgia one of the countries with the highest levels of income inequality in the European and Central Asian region.

Inequality of opportunity also appears to be high. For example, results from the 2015 round of the Program for International Student Assessment (PISA) show sharp differences in learning outcomes by socioeconomic status, urban/rural location, gender, and exposure to preschool (figure 2.7). Every 30-point difference in PISA score corresponds to a difference of about one year of schooling. By this reasoning, the difference in science scores between

children (of the same age, or grade) in the top and bottom quintiles of the socioeconomic distribution is equivalent to three years of schooling.¹

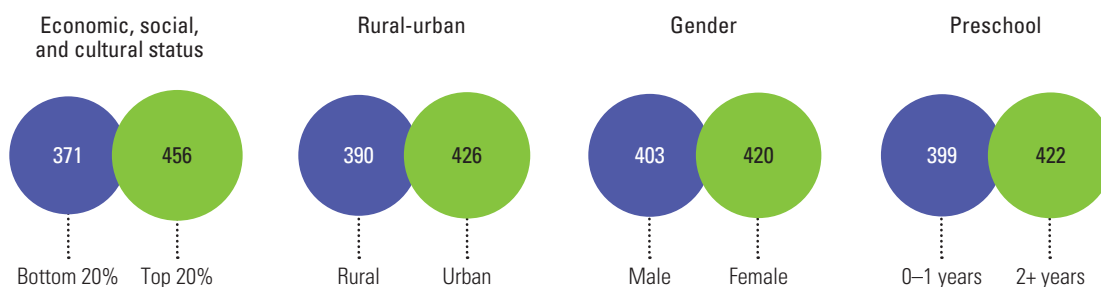
Wages, Pensions, and Social Assistance Have Been Drivers of Poverty Reduction and Shared Prosperity

Wages, pensions, and social assistance have been driving household income growth. Income from economic activities, namely labor and agricultural, constituted close to half of total income for the poor in 2015 (47 percent). With the expansion of social spending in recent years, income from social assistance (including noncontributory old-age pensions) came to account for 41 percent, mainly comprising pensions (27 percent) and targeted social assistance (TSA) (11 percent) (figure 2.8). Labor income (that is, wages) is relatively more important in Tbilisi and other urban areas, while agricultural income

FIGURE 2.7

Significant Gaps in Learning Outcomes for Children from Different Social Backgrounds

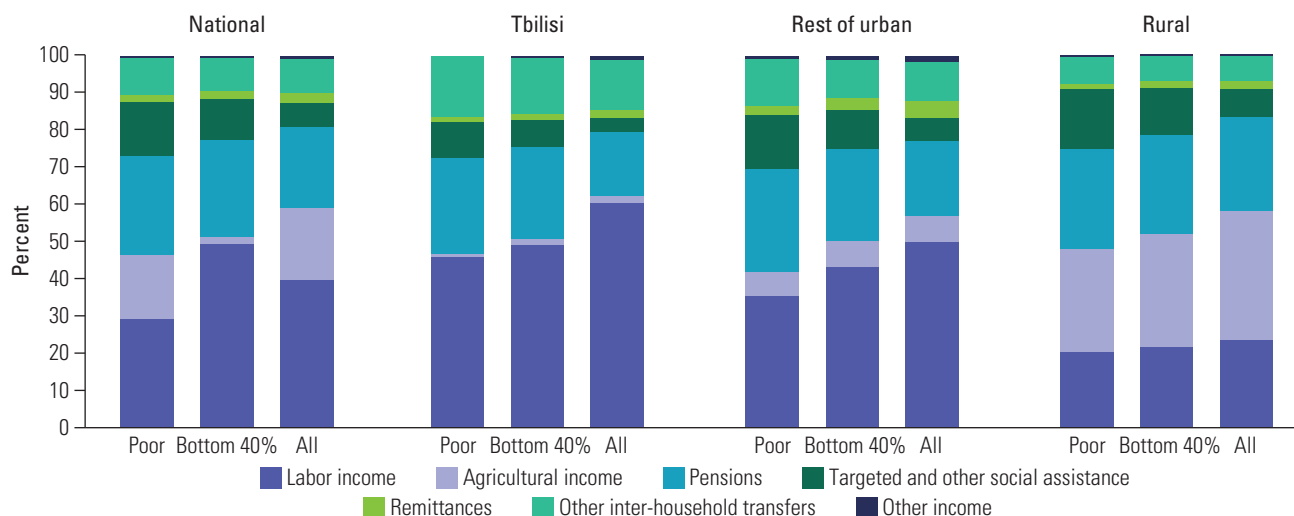
Average science scores in PISA, 15-year-olds, 2015



Source: Adapted from OECD 2015.

FIGURE 2.8

Income from Pensions and Social Assistance Is Almost as Important as Income from Employment and Agricultural Activities for the Poor in Georgia, 2015



Source: World Bank staff calculations based on data from the IHS database (Geostat).

Note: Social assistance includes noncontributory pensions.

dominates in rural areas (28 percent). However, labor income still contributes more than 20 percent of total income for the poor in rural areas, suggesting that they have been able to access some opportunities outside of self-employment in agriculture. The income from international remittances represents a modest share, but inter-household transfers within the country are nonnegligible. Relative to the population as a whole, (as expected) the poor rely to a much greater extent on social assistance.

Pensions and social assistance helped to maintain household income during the period of crises, but labor income has become a more important driver after 2010. Average household income growth was roughly constant (7 percent per year) from 2006–15. During the period of crises in 2006–10, social assistance (mainly noncontributory pensions) and inter-household transfers accounted for close to 80 percent of observed growth in household incomes, mitigating adverse shocks to earned income. In contrast, income from labor markets and agricultural sales became more prominent post-2010, explaining over 80 percent of observed income growth (figure 2.9).

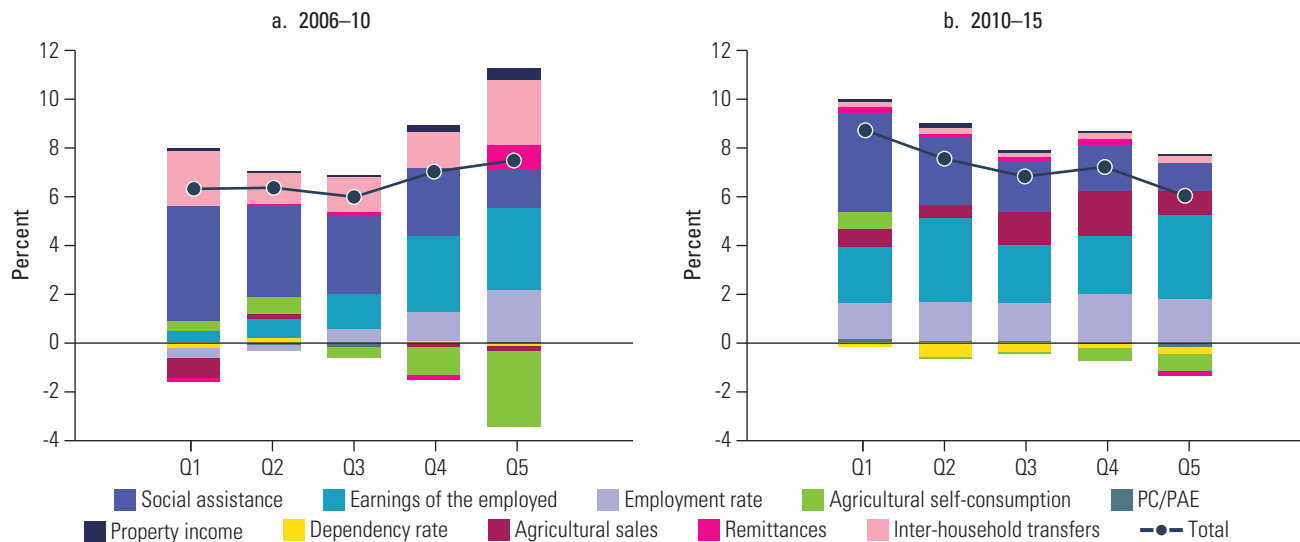
This was particularly pronounced for those at the bottom of the income distribution. Between 2006 and 2010, income from transfers was, by and large, the sole driver of income growth for those in the bottom 40 percent of the income distribution. Given that poverty actually increased between 2006 and 2010, this suggests that poverty would have gone

up even more during this period if social assistance had not been available. After 2010, higher rates of employment and faster growth of labor incomes drove overall household income gains. The share of social assistance decreased to close to 30 percent. This result is also reflected in the drivers of poverty reduction. Transfers were the main drivers of poverty reduction before 2010, while economic activity became more prominent thereafter (figure 2.9).

Dynamics for male- and female-headed households were similar over 2006–10, but over 2010–15 male-headed households benefited more from the employment opportunities created during that period. In contrast, female-headed households benefitted equally from pensions and an increase from labor income. This is large due to the much larger number of female pensioners.²

Although social assistance is an important lifeline for the poor, providing better opportunities in the labor market is the surest way out of poverty. Between 2009 and 2015, incomes increased for both the chronic poor (those who were poor in 2009 and remained poor in 2015) and “escapers.” For the chronic poor, incomes rose thanks to increases in social assistance, while for the “escapers” labor earnings constituted the main driver for escaping poverty. Although consumption increased only marginally for the chronic poor, their income almost doubled over the same period, thanks mainly to increases in social transfers (TSA and pensions). In contrast, “escapers” not only experienced faster income growth (135

FIGURE 2.9

Overall Household Income Growth Constant but the Drivers Were Different, 2006–15

Source: World Bank staff calculations based on data from the HIS database (Geostat).

Note: Social assistance includes noncontributory pensions.

percent), but also more than proportional consumption growth (200 percent).

Challenges Ahead

First, poverty remains high. Today, roughly one in five Georgians is still poor, based on the national poverty line. Poverty in Georgia measured using the global poverty line for lower middle-income countries (US\$3.2 per day 2011 purchasing power parity) is only behind Tajikistan in the Europe and Central Asia region (considering only those countries with available data) and higher than in neighboring Armenia, a country with a similar level of gross domestic product (GDP) per capita. Georgia is also poorer (that is, it has a higher incidence of poverty) than other lower middle-income country peers, despite having a higher GDP per capita in some instances.³

Second, close to half of the population remains vulnerable to falling into poverty. With the decline in absolute poverty, there has been a corresponding increase in the country's middle class, which grew from roughly 12 percent in 2009 to 30 percent in 2015.⁴ However, the share of the population that is vulnerable—where vulnerability is defined as having a probability of falling into poverty larger than a low threshold of 10 percent—hovered between 47 and 54 percent of the population during this period (figure 2.11). High vulnerability implies that small shocks can push many households into poverty.

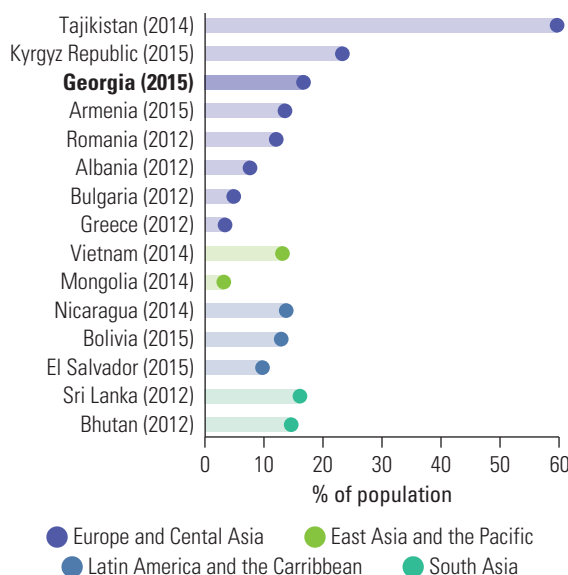
For instance, an estimation of the net impact of the 4.0 percent inflation witnessed in 2015 shows that poverty incidence increased by close to 3 percentage points just on that account. Impoverishment from health spending is another example: 6.6 percent of Georgian households became poor in 2015, entirely due to out-of-pocket health expenditures. Vulnerability manifests itself in the high degree of churning around the poverty line. Close to half of the households identified as poor in 2011, 2013, and 2015 were not poor in the previous period, which shows considerable movements in and out poverty (figure 2.12). Among the non-poor, there is greater stability from one period to the next, but still close to one-fifth of the non-poor in one period fall into poverty in the next.⁵

Third, while overall inequality has declined, there are persistent welfare disparities across geographic domains. Inequality, as measured by the Gini coefficient, fell from a peak of 40 points in 2011 to close to 36 in 2016 (based on the consumption aggregate used for international poverty comparison). Nonetheless, inequality is still among the highest in the Europe and Central Asia region and is evident along geographic and demographic dimensions. For instance, regions located in the eastern parts of the country surrounding Tbilisi have poverty rates considerably higher than in the western regions or in Tbilisi. Similarly, along the urban-rural divide, the gap between rural and urban poverty rates has broadly been stable over the past decade,

FIGURE 2.10

Poverty Is Still High by Regional and Global Standards

Poverty estimates at US\$3.20 per day, selected countries, PPP



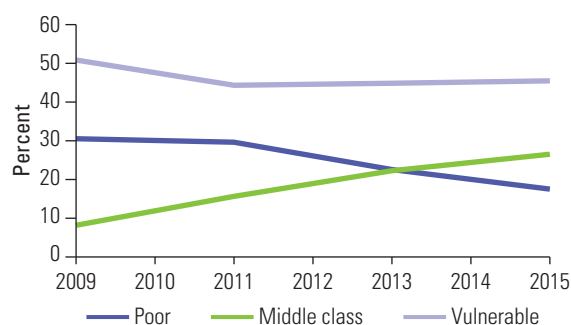
Source: World Bank staff calculations based on data from the World Bank Global Poverty Working Group database.

Note: Countries included are European and Central Asian countries with poverty higher than 3 percent and other lower-middle-income countries with poverty levels lower than Georgia in 2015; PPP = purchasing power parity, 2011 prices.

FIGURE 2.11

The Poor, the Vulnerable, and the Middle Class

2009–15



Source: Adapted from Tiwari and others 2017.

Note: The definition of the middle class follows Lopez-Calva and Ortiz-Juarez (2014). The underlying data draws from the WMS[PI: Please provide meaning.], which is a panel survey of Georgian households. The aggregate poverty numbers may not align exactly with the official numbers, which are calculated using data from the IHS database (GeoStat).

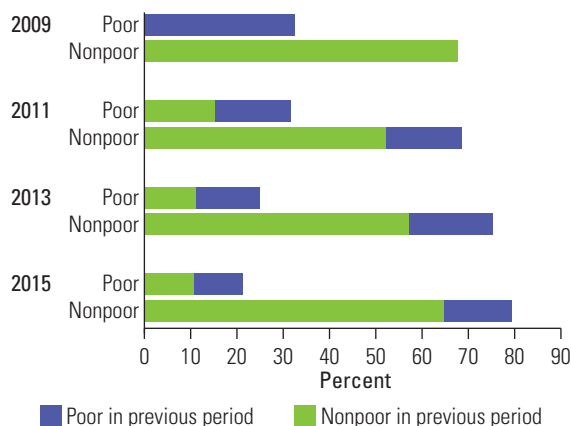
at an average of around 8 percentage points. While some differences in welfare across space are to be expected in any country, persistent gaps potentially signal a chronic lack of economic opportunities in lagging regions (figure 2.13) combined with limited mobility for these populations.

Eradicating poverty will require targeting efforts on the groups where poverty is entrenched.

FIGURE 2.12

Moving out and Back into Poverty: Distribution of the Poor and Nonpoor

Poverty status in the earlier period, 2009–15



Source: Adapted from Tiwari and others 2017.

Note: The definition of the middle class follows Lopez-Calva and Ortiz-Juarez (2014). The underlying data draws from the WMS, which is a panel survey of Georgian households. The aggregate poverty numbers may not align exactly with the official numbers, which are calculated using data from the IHS database (GeoStat).

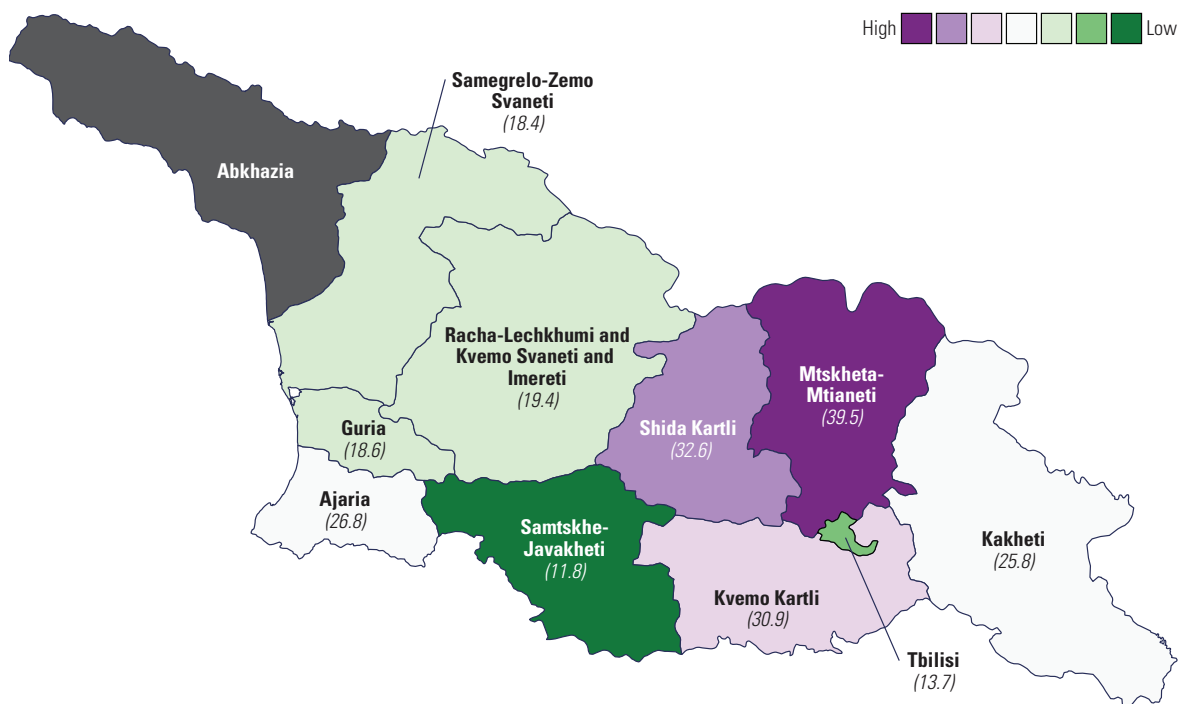
Poverty is mainly rural, and poverty levels observed in Tbilisi are substantially lower than in most other parts of the country. This is not surprising, as cities have been the main beneficiaries of the gains in welfare in the past 15 years, while rural areas lagged behind. The poor tend to have lower levels of educational attainment, to be self-employed as agricultural workers in rural areas, or unemployed in cities. Female-headed households have a higher likelihood of being poor and/or belonging to the poorest 40 percent. Rural households with an unemployed head have the highest poverty rate, with more than half of this group living in poverty (World Bank, 2016). Elderly households living off pensions are protected from poverty, but households with dependents—children under the age of 18 or elderly over 65—have a higher poverty rate (35 percent) than those without dependents. The poor live in larger households and, particularly in rural areas, have a larger number of children in the household.

With high remaining poverty levels, rekindling the jobs engine will be key. The analysis of poverty trends and drivers reveals that growth failed to benefit the poor, where it was not accompanied by employment creation. Since labor market opportunities have been the only reliable ticket out of poverty, a key priority is to ensure that the country not only grows, but that it does so in a manner that also gives more Georgians access to productive employment.

FIGURE 2.13

Poverty Rates Vary across Space in Georgia

% of population, 2016



Source: World Bank Group staff calculations using data from the IHS database (Geostat).

A twin challenge is to address widespread vulnerability. The significant amount of vulnerability in the population, as evidenced by the churning around the poverty line, suggests that major structural bottlenecks remain in the economy. Moreover, the pattern of growth observed in recent years appears to have been insufficient to overturn an uneven landscape of economic opportunities that excludes large segments of the population from being productive and contributing to overall growth.

Notes

1. Kazakhstan 2009–13: bottom 40 percent welfare annual growth is 8.94 and average welfare annual growth is 7.56; Russian Federation 2007–12: bottom 40 percent welfare annual growth is 5.86 and average welfare annual growth is 5.27.

2. Female-headed households are more likely to be older, with an average age of the head of 65 years of age, compared with 57 for male-headed households. Rural households headed by women have the oldest heads at 70 years of age on average, compared with 59 for men.

3. Earlier, the global poverty line applicable to Georgia used to be US\$2.50 per day in 2005 purchasing power parity (PPP). But with the 2011 PPP adjustments now available, the relevant poverty line is the lower-middle-income

country poverty line of US\$3.20 per day in 2011 PPP. The other global poverty lines that are reported by the World Bank are US\$1.90 per day for low-income countries and US\$5.50 per day for lower middle-income countries. Georgia was ranked as upper middle-income in 2016 but was downgraded in 2017.

4. The definition of the middle class used follows the risk of falling into poverty approach as described in Lopez-Calva and Ortiz-Juarez (2014). The method entails using panel data to estimate probabilities of falling into poverty for households between two periods and identifying those with a sufficiently low probability of falling into poverty as belonging to the middle class.

5. Tiwari and other (2018).

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CHAPTER 3

SUSTAINING GROWTH AND CREATING JOBS

In order to continue on its path toward prosperity, Georgia needs to maintain its growth rate at or above 5 percent. At this rate, by 2030, Georgia will eradicate extreme poverty and Georgians will be twice as well-off as they are today. However, continued growth will not come from domestic demand and low-hanging productivity gains, but from boosting export orientation and addressing horizontal productivity constraints.



Findings

- Given population trends, Georgia will not be able to rely on higher labor force participation solely to boost growth.
- Barring an unrealistic increase in the savings rate, total factor productivity (TFP) growth will be key to future economic growth, as will boosting the skills of current and future workers.
- Four sectors—tourism, commercial agriculture, textiles and apparel, and hydropower—display high potential as drivers of export-led growth.
- Trade logistics, connectivity, and human capital remain important productivity constraints.



Recommendations

- To boost productivity, Georgian firms will need to integrate into global value chains (GVCs) by attracting foreign direct investment (FDI) and resolving logistics bottlenecks.
- Georgia has an opportunity to add dynamism to its lagging rural economy by modernizing agriculture and leveraging tourism potential.



Lia Aleksishvili, a resident of Telavi in Kakheti region, remembers when her currently bustling bakery was only a small grocery store that could barely sustain herself alone. Over the years, she has managed to transform the small shop, which was struggling to make ends meet, into a successful local bakery. The expansion of her business has been beneficial not only to herself, but also to the community, because as her enterprise grew so did the amount of effort required to run it. Currently, Lia's bakery employs four full-time workers and, when the holiday season arrives and the demand for desserts and pastries is at its highest, she employs four additional workers part-time. This could have been a satisfying end to a success story. However, in the true spirit of entrepreneurship, Lia also managed to invest the profits from her business into renovating the second floor of her bakery, turning it into a bed and breakfast to capitalize on the rising number of tourists.

The first and foremost challenge for Georgia is to sustain high rates of economic growth. Georgia does not have a growth problem per se: given its unique demography, Georgia would do well by maintaining the average growth rate of the past decade going forward, as this would translate into significant per capita gains. If its economy grows at an average rate of 4.5 percent, this performance would result in per capita growth of 5 to 6 percent, and thus in a doubling of living standards by 2030. But this will not be easy and the pathways followed to date will need to be recalibrated.

To grow continuously and sustainably at or above 5 percent, Georgia will need to reorient its economy. Until now, most growth has been driven by domestic demand, boosted by remittances and capital inflows, and by leveraging “easy” productivity gains from sectoral reallocations and first-generation reforms. Henceforth, Georgia will need to tap increasingly into external markets through boosting the production of tradables (expanding on earlier success in tourism and apparel), and ensure that productivity continues to improve through efficiency gains at the firm level.

An additional challenge will be to make growth more inclusive, through job creation, including in rural areas. While economic growth has benefited Georgians via higher wages and more resources for the state to redistribute, it has failed to create jobs on a scale sufficient to reduce unemployment significantly, or provide opportunities for under-employed rural residents. Most job growth has taken place in traditional services rather than modern productive sectors. Meanwhile, much of the gain made on social outcomes has been achieved thanks to redistribution and social assistance, which mostly provide temporary relief but little durable exit out of poverty. This has also come at a significant fiscal cost, and resulted in an erosion of fiscal buffers, which must now be rebuilt.

What will it take Georgia to build on its strong foundation? To boost productivity, sustain high rates of growth and create good jobs, Georgian firms will need to tap into GVCs and foreign markets, including digital and financial value chains:

- **Attracting FDI will be key.** In the short term, it is international companies that can provide the scale and expertise to connect Georgian products to international markets. This is also the best strategy to reduce “discovery costs”—which are particularly

high in Georgia—for exporting companies. With more FDI and larger firms, productivity will rise.

- **Logistics remains a core bottleneck.** Georgia’s ability to boost trade and attract FDI is undermined by weak logistics. In today’s economic world, which is dominated by GVCs, timely and high-quality delivery is more important than cost, and Georgia urgently needs to do better on this front. An important weakness is Georgia’s lack of adequate financial integration.

In seeking greater trade integration, Georgia needs a comprehensive strategy. The country has a good base to build upon. Trade with Turkey is growing, especially in apparel, tourism is booming, and the trade agreement with the European Union (EU)—Deep and Comprehensive Free Trade Area—has created an opportunity to bring Georgia’s systems into line with international standards. At the same time, history suggests that most trade between countries is with neighbors. Therefore, Turkey and the Russian Federation will remain Georgia’s most important markets for economic development.

What Will Drive Growth in the Long Run?

To make economic growth more sustainable and double GDP per capita by 2030, Georgia needs to rebalance its economy from investment-led to productivity-led growth. Given demographic dynamics, labor force growth cannot become a meaningful driver of economic growth, even with higher labor participation. Therefore, the two remaining potential drivers of economic growth are capital accumulation and productivity. In turn, if TFP growth remains at current levels, and assuming a gradual decline in the current account deficit to keep external balances at sustainable levels, Georgia will not be able to double its per capita GDP by 2030 without an unrealistic increase in savings to 35 percent of GDP by 2030, against an average of 17 percent since 2000. However, the target can be reached, with no additional savings growth and lower rates of investment, if TFP growth accelerates from 1 to 2 percent over the medium-term (box 3.1).

Productivity-enhancing reforms are critical to achieve the required rates of long-term economic growth. While few countries have managed to achieve TFP growth rates above 2 percent over the years, this is less than the rate of postreform TFP growth experienced in Georgia during the 2000s.

BOX 3.1

Growth Accounting: Why Raising Total Factor Productivity Will Be Key

Using a long-term growth model, we simulate what it would take for Georgia to double its gross domestic product (GDP) per capita by 2030. The model assumes a gradual closing of the current account deficit and also factors in the shrinking labor force. More specifically the model calibrations include:

- A gradual decline in the current account deficit from 11 percent of GDP currently to 5 percent of GDP by 2025 and going forward.
- A decline in the labor force by about 15 percent between 2015 and 2030, based on current population projections and a stable labor force participation rate.
- Average annual GDP per capita growth rate of 4.8 percent, the rate required to double GDP per capita by 2030.

The main conclusion is that raising TFP will be key

In a “baseline scenario, total factor Productivity (TFP) growth is kept constant at 1 percent per year (based on the 2011–15 average for Georgia). In this scenario, reaching the growth target would require a higher level of investment from around 30 percent currently to over 40 percent by 2030, which in turn would require an unrealistic increase in the savings rate.

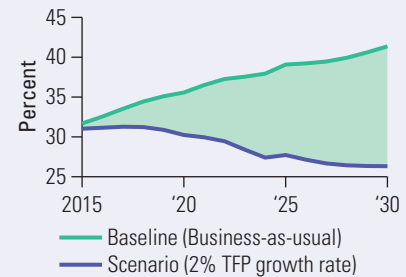
In an alternative scenario, where TFP growth increases to 2 percent by 2025, Georgia can double its GDP per capita by 2030 with no additional savings. The required level of investment moderates from 30 to 26 percent, which requires savings rates similar to historical values of around 20 percent of GDP. Hence, with a

higher rate of productivity growth, achieving a doubling GDP per capita by 2030 becomes possible (figure B3.1).

FIGURE B3.1

Required Investment-To-GDP and Saving-To-GDP Ratios to Double GDP per Capita by 2030

Model output simulation 2, to achieve 4.8% GDP per capita growth rate



Source: World Bank Group staff calculations.

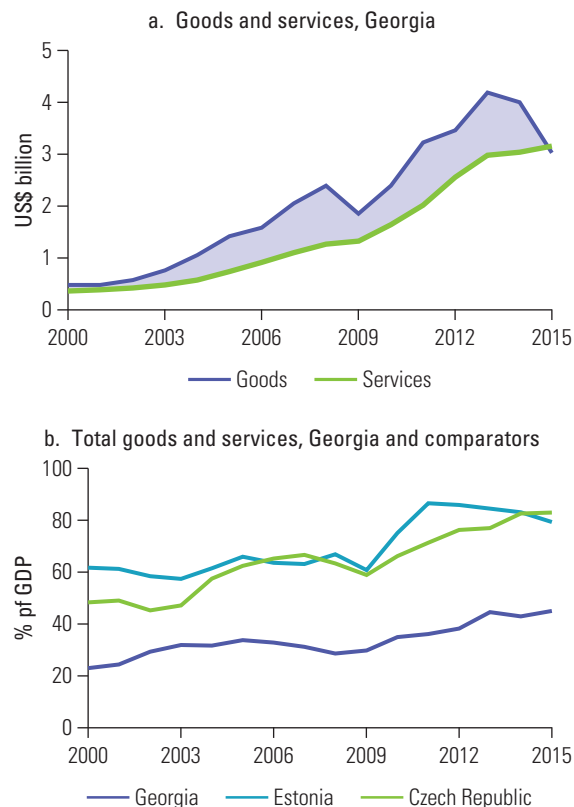
However, replicating that performance (which was in part achieved at a time of economic restructuring and factor reallocations) would require a significant increase in export orientation to allow productive firms to grow and to boost competition in the market. The remainder of this chapter identifies potential drivers of productivity growth at the level of the economy, firms, and individuals.

Unleashing New Sources of Growth through Integration into Global Markets

A higher rate of productivity growth could be achieved by increasing Georgia's export orientation. Since Georgia does not have substantial natural resources or a large domestic market, future GDP growth and job creation will hinge on its ability to produce and sell goods and services competitively in the global marketplace.

Successful countries have integrated their economies with the rest of the world. Small countries with fewer than 10 million people need exports to rise to at least 50 percent of GDP if they are to avoid a ‘middle-income trap’. Georgia's total exports of goods and services have expanded over the past 15 years, rising from 23 percent of GDP in 2000 to 45 percent in 2015 (figure 3.1). Nonetheless, Georgia's

FIGURE 3.1

Dynamics of Exports

Source: World Bank staff calculations based on data from UN Comtrade and IMF Balance of Payments Statistics.

exports are well below those of more advanced peers, such as Estonia and the Czech Republic, whose exports are equivalent to about 80 percent of GDP. Slovakia increased its exports-to-GDP ratio from 45 percent (in the early 1990s) to 93 percent today.

The number of export-oriented firms has been increasing, albeit slowly. There were 1,177 exporters in 2003, and 1,835 in 2012, revealing substantial net entry (table 3.1). Net entry contributed to more than half of export growth during 2009–12, with the rest stemming from diversification along the market dimension. In 2012, on average, exporters reached two to four destinations, with four to five products, diversifying from their patterns in 2003. However, most exporters were relatively small, with 40 percent of firms exporting only one product to one destination, and low chances of survival (table 3.2).

The composition of Georgia's export basket has not evolved in a significant way. Georgia has increased its market reach from about 60 destinations in the early 2000s to more than 100 in the early 2010s, exporting around 2,000 product varieties (figure 3.2). While this is better than Armenia and Azerbaijan, there is still substantial scope for further diversification, as demonstrated by the better performance of small and former transition economies currently members of the EU (Czech Republic, Slovakia, and Lithuania), or associated through a trade agreement (Bosnia and Herzegovina and Serbia). Resource-based products such as minerals and metals, and the re-exports of used cars, are still dominant. In 2015, Georgia exported competitively 30 agribusiness products accounting for about one-quarter of total merchandise exports (see appendix I). The only new competitive exports in the manufacturing sector included apparel (11 product groups, 6 percent of the total merchandise exports) and medicaments (one new product group, 5 percent of the total merchandise exports). The export of services, while growing, has been limited to tourism, which is currently the most dynamic export sector in Georgia. Transport services exports grew very modestly and other business services, such as telecommunications and IT, finance and insurance and other global services, maintained negligible export shares.

The survival of firms in export markets is a challenge. Georgian firms, as those in Armenia and Albania, have low survival chances in the global marketplace. Out of 100 export flows that start in a given year, only 40 remain active after the first year, two years later, 20, and just five at the end of the fifth year.

TABLE 3.1
Georgia's Exporting Firms

a. Total number				
	2003	2006	2009	2012
No. of firms	1,177	N/A	1,462	1,835
No. of destinations	80	98	99	112
No. of products	1,100	1,497	1,584	2,024

b. Average for all exporters				
	2003	2006	2009	2012
No. of destinations	1.63	1.51	1.86	1.88
No. of products	2.6	2	3.79	4.46

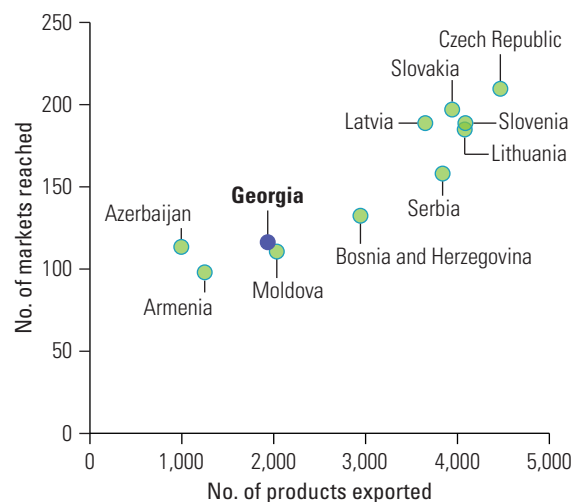
Source: Adapted from World Bank (2013) using data from Geostat.

TABLE 3.2
Export Survival Probabilities

	1 year	2 years	5 years
Slovenia	59.1	42.0	23.6
Hungary	54.6	37.3	19.2
Serbia	48.9	30.4	13.9
Bosnia and Herzegovina	47.8	29.2	13.4
Moldova	45.9	26.9	11.4
Albania	38.9	20.7	7.1
Georgia	39.5	19.9	5.5
Armenia	36.8	16.8	5.0

Source: Adapted from World Bank (2013) using data from Geostat.

FIGURE 3.2
Diversification of Merchandise Exports



Source: World Bank staff calculations based on data from UN Comtrade and IMF Balance of Payments Statistics.

This reveals that firms explore markets and opportunities through trial and error, and with highly imperfect information, before entering export markets.

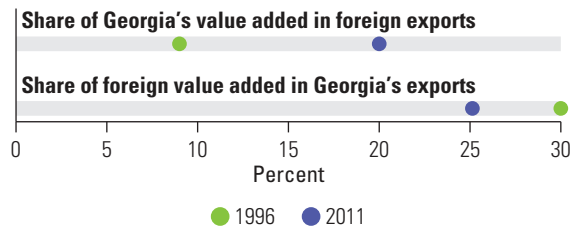
To lower “discovery costs,” attracting FDI will be critical. Scarce information on business opportunities, the specificities of exporting to a given country, foreign consumers’ preferences, or the regulatory complexities associated with serving foreign markets may be limiting the growth potential of firms and affecting export survival. Initiatives to make information more easily available to firms can be a useful step. Experience suggests, however, that attracting foreign investment is key. In the hazelnut sector, the presence of the Italian firm Ferrero set the example to hazelnut producers that it was profitable to export this product. The State Partnership Fund, with the U.S. Agency for International Development support, mobilized farmers to export tangerines, providing information and financial resources to improve the parameterization and packaging of fruit, and introducing ‘consolidators’ that buy from several farmers and put together the produce, so that a minimum efficient scale is reached.

For small economies, GVCs can be powerful platforms for integration. Georgia’s backward GVC integration—measured by the portion of foreign value-added embedded in a country’s exports—has been increasing, albeit from very low levels. This suggests that Georgian firms increasingly rely on foreign intermediates in order to produce for export. The sharp increase in tourism exports over the period, along with that of other downstream merchandise sectors such as garments, explains this increase. However, the share of Georgia’s exports that ends up in foreign exports—forward GVC integration—was at 26 percent in 2011, down from about 30 percent in 1996 (figure 3.3). It is in textiles and apparel that firms have most successfully managed to integrate with international production networks. For agribusiness exports, the share of Georgia declined from 0.18 percent in 2001 to 0.02 percent in 2015. This is a concerning development, given the country’s strong comparative advantages (see section on firm level constraints).

Georgia has significant underleveraged potential for export-led growth. For Georgia to reach higher levels of income, it needs to succeed in generating international “breakthroughs” in key sectors. The Systematic Country Diagnostic analyzed four sectors in which Georgia has great export potential if it maintains reform momentum and succeeds in

FIGURE 3.3

GVC Integration, 1996 and 2011

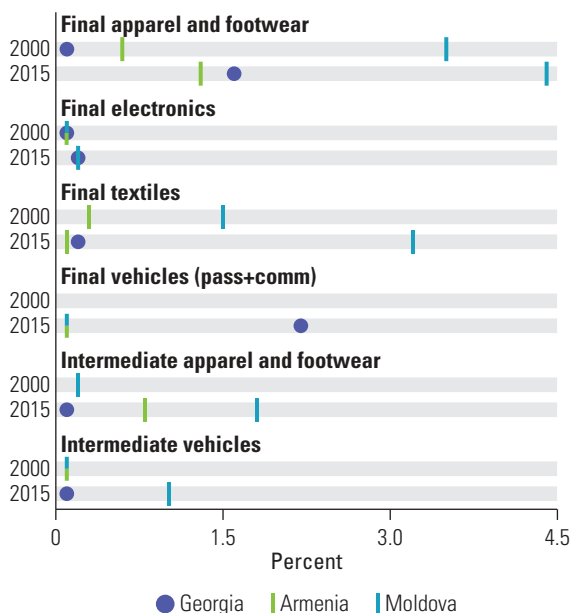


Source: World Bank staff calculations based on data from UNCTAD-EORA GVC database.

FIGURE 3.4

Global Market Shares

Georgia and comparators, 2000 and 2015



Source: World Bank Group staff calculations based on UN Comtrade.

implementing international standards (see box 3.2 for policy priorities).

Firm-Level Constraints

Despite positive recent trends, Georgia remains far from the productivity frontier. Firm-level analysis shows that productivity has been growing because of productivity increases by individual firms (the distribution of productivity shifted to the right), and of productivity dispersion narrowing mildly. This suggests an improvement in resource allocation toward the most productive firms. However, comparisons with peer economies show that there is still significant scope to boost productivity growth further.

BOX 3.2

In Which Sectors Can Georgia Boost Its Export Potential?

Agriculture

The agrifood industry has considerable untapped potential.

It has strong commercial potential, thanks to fertile land, favorable agro-climatic conditions, ample water resources and unique traditions. Growth opportunities stem from the rapid expansion of high-value fruit and vegetable consumption in traditional Commonwealth of Independent States markets, as well as improved access to the European Union (EU) and Chinese markets.

Policy priorities for the sector would therefore include:

- **Land market development.** While smallholder farming can be efficient, formalizing/legitimizing land property rights will be fundamental for attracting greater investment.
- **Cooperation among smallholders** on service provision, product consolidation, processing, branding, and marketing to reach efficient scale.
- **Compliance with food safety and quality standards.** Georgia has invested heavily in building the capacity of the National Food Agency, harmonizing food safety legislation with EU legislation in line with the Deep and Comprehensive Free Trade Area (DCFTA), and developing disease control strategies. However, ensuring compliance will be a challenge.
- **Addressing underlying failures in agro-credit market.** Promoting supplier finance, while making efforts to reduce risks in agriculture would pave the way for farmers' engagement with commercial banks in the longer term.
- **Value-chain infrastructure, including storage and sorting facilities.**
- **Public-private dialogue to inform strategy and actions for agriculture development and promote greater producer-buyer coordination.** In the medium-term, these could evolve into industry associations to support export promotion, standard setting, and industry compliance.

Tourism

Georgia's tourism sector is a major contributor to gross domestic product, exports and employment but faces constraints to further expansion beyond traditional markets.

Between 2009 and 2016, Georgia achieved one of the fastest rates of tourism growth globally. Nonetheless, it still struggles to attract tourists from outside the region. Moreover, the sector still relies heavily on foreign inputs and could do better in integrating domestic suppliers.

Policy priorities for the sector include:

- **Regulatory controls** to ensure compliance with: (i) minimum standard expectations of larger international tour operators; (ii) demands of certain segments such as third-age travelers; and (iii) requirements for soft adventure markets where safety standards are important.
- **Standardized visitor management processes for heri-**

tage sites. With an overwhelming number of historical monuments and a limited budget, some sites are neglected. This calls for introducing "site management plans", training local professional staff and improving supporting infrastructure.

- **Expanding hospitality training,** particularly in rural areas and focusing not only on the needs for relatively well-established product offerings, but also of other promising market segments.
- **Tourism-related infrastructure,** including affordable, quality hotels and connectivity infrastructure (domestic connections along touristic circuits and international air connections).^a

Energy

With vast hydropower potential and a favorable location, Georgia could become an energy hub.

The country has large unexploited hydropower potential, which could generate significant export receipts.^b It also has a significant locational advantage to exchange power between energy producers, such as Azerbaijan and the Russian Federation, with energy consumers such as Turkey and Armenia.

Policy priorities for the sector would include:

- **Power market development,** including introduction of the short-term market, balancing and ancillary services market.
- **Public-private partnership (PPP) frameworks.** Creating an enabling framework and/or structures for PPPs, so the private sector can attract the needed investment in grid infrastructure, while at the same time heightening scrutiny over the potential contingent liability that PPP projects entail.
- **Regulations for cross-border trade.** Regulations that are particularly important for cross-border trade are those around grid connection. The cross-border capacity allocation rules are currently being clarified, but some concerns remain about the development of the Turkish grid. To address this and other barriers to regional power trade, Georgia and Turkey will need policy decisions and a roadmap with coordinated measures.
- **Strengthen incentives to reduce technical and commercial losses in distribution.** Currently, transmission and distribution tariffs are regulated according to the cost-plus principle, so distribution companies have limited incentives for reducing losses and improving efficiency.
- **Environmental and social impact assessments.** A more systematic assessment of environmental and social impacts is needed, including the cumulative impacts from the development of multiple hydropower plants in the same river basin.

Apparel

Textiles and apparel firms have been successful in integrating into international production networks and the

(Box continues next page)

Box 3.2. (continued)

challenge is now to move up the value chain. The challenge is twofold: remaining price competitive to be able to serve more than one destination, and moving up the low margin cut-make-trim activities into fashion design, introducing new styles and quality labels, targeting high-end users.

Policy priorities for the sector would therefore include:

- **Sector specific skills programs**, to encourage on-the-job training to foster cluster-wide externalities, as well as strengthening vocational education, particularly with a focus on textiles and apparel and connected activities, and new skills related to digital drawing, printer operations and template-making.^c
- **Logistics and standards.** In addition to improving logistics, reducing trade costs, and ensuring harmonization of standards

with key trading partners through deep agreements is also crucial. An example of a deep agreement is the DCFTA signed with the EU. With other partners, Georgia could benefit from deepening its integration efforts into services and investment, as they play a key role in the economy's competitiveness and specifically on textiles and garments. For firms that focus on original design and display small scale, leveraging alternative business and distribution models (for example, e-commerce platforms catering to foreign clients) would be critical.

a. Peru's experience with developing its gastronomical/tourism corridor could provide a useful example of a successful implementation of the tourism strategy. Peru shares many of the challenges with Georgia, including the mountainous landscape and isolated communities.

b. Estimated at conservative price of US\$0.06 per kilowatt hour.

c. Firms also mentioned that in cut-make-trim segments, where margins are tight, exchange rate volatility appears to be an obstacle.

Firms Are Mostly Small and Informal

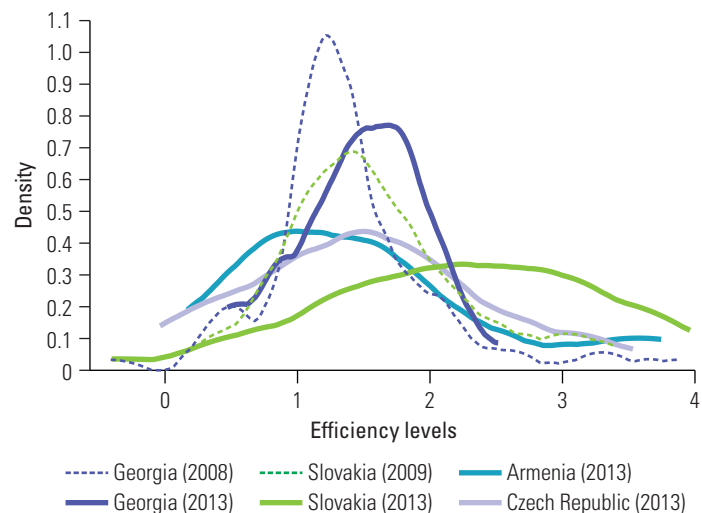
To become more productive, firms need to be able to grow and formalize, and Georgia has had mixed results on this front. Firm size has been decreasing during the past decade, mostly for good reasons. First, the privatization of state-owned enterprise (SOEs) has presumably forced some restructuring of large inefficient SOEs, leaving the smaller and more productive ones in the market. Second, reforms in the business environment have allowed more private firms to enter and new firms start small. In recent years, employment growth has accelerated over the life-cycle of firms. The growth rate of employment across firms of different ages was flat in 2007, and progressively increased thereafter. For example, a typical five-year-old firm was as large as it was at birth in 2007, but twice as large in 2014. This suggests that firms manage to secure labor and financial capital as profit opportunities arise, including through making use of the “Produced in Georgia” program and probably also thanks to improvements in the investment climate.

However, many firms still operate in the informal sector, with limited opportunities for growth. The introduction of preferential tax regimes for Georgian micro and small businesses made it easier for micro firms to file taxes (they were exempted from income tax) and it induced a sharp and one-time-only increase in the number of registered firms by 27 to 41 percent (Bruhn and Loeprick 2014). This suggests that informal firms registered at that time. However, informality appears to remain prevalent

FIGURE 3.5

Less Dispersion and Some Growth in Georgian Firms' Productivity

Georgia and comparators



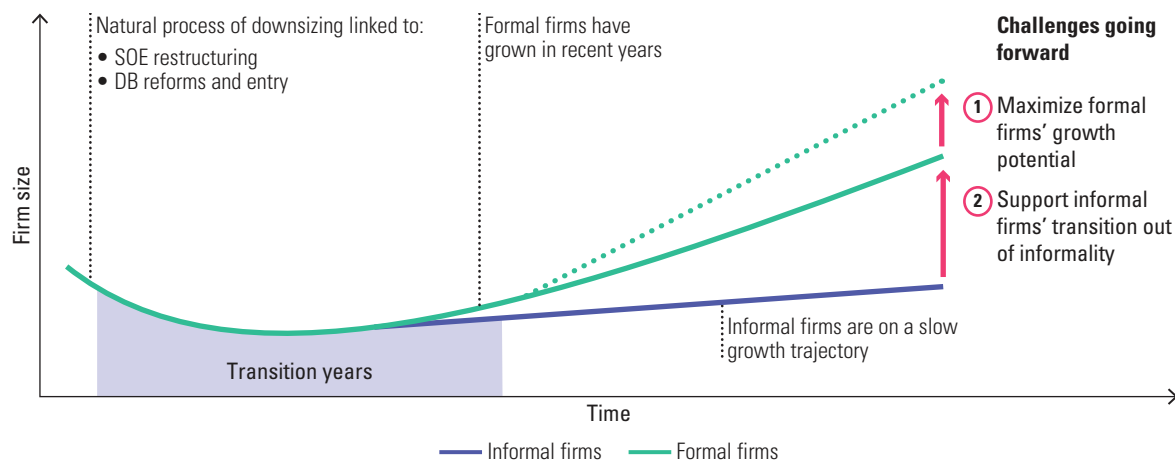
Source: World Bank staff calculations based on World Bank's Enterprise Surveys.

Note: Productivity estimate is based on a production function on output that includes materials, capital and labor as regressors.

in a handful of sectors such as foodstuffs, retail and wholesale, construction and hotel and restaurant sectors. Due to land fragmentation (in the first sector) and low managerial capabilities (in the rest), it is likely that the scope for firm growth is limited, and therefore the costs of formalizing may outweigh the benefits. This conjecture should be subject to future research.

While formal firms do grow, those in the informal sector do not. The substantial growth dynamics outlined above hold mostly for formal firms. In stark

FIGURE 3.6

A Twin Challenge: Sustaining Formal Firm Growth and Tackling Informality

Source: Georgia SCD team.

contrast, individual firms tend to stay small over their life-cycle. Given the prevalence of informality in Georgia, a major share of the economy is thus still dominated by undynamic firms.

Going forward, policymakers will need to prioritize not only support to small and medium enterprises (SMEs) but also growth and formalization. Subsidies and regulatory favors to small business can constitute incentives to stay small and, in many cases, inefficient. In a healthy economy, it should be easy for entrepreneurs to start companies, the best of which should be able to grow, thereby benefiting from fair competition and access to the required

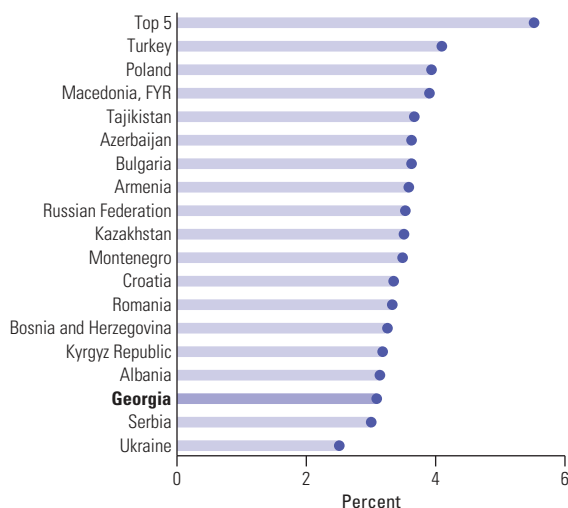
inputs (including credit, labor, and technology), while inefficient firms should be allowed to fail.

Although Georgia has a competition regulatory and institutional framework in place since 2012, the degree of competition remains low, especially compared to peers. According to the World Economic Forum's Global Competitiveness Report (2016–17), perceptions of competition in Georgia are weak, particularly with regard to the effectiveness of its antimonopoly policy (3.1 out of 7 points) and the extent of market dominance (3.6 out of 7 points) (figures 3.7 and 3.8). In turn, key sectors, such as manufacturing, exhibit market structures prone to

FIGURE 3.7

Effectiveness of Anti-Monopoly Policy

Georgia and other European and Central Asian Countries

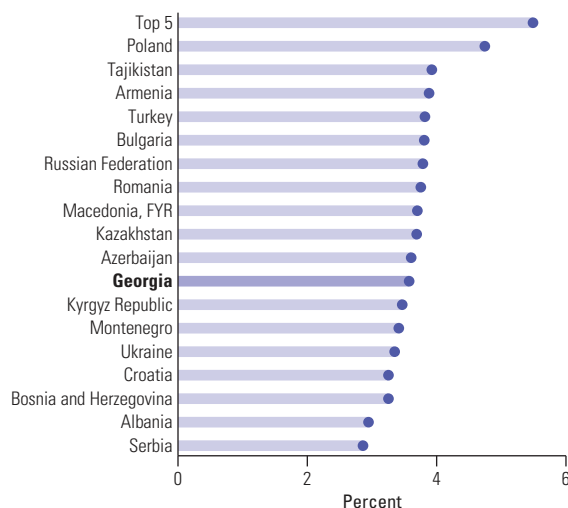


Source: Adapted from WEF 2016.

FIGURE 3.8

Extent of Market Dominance

Georgia and other European and Central Asian Countries



Source: Adapted from WEF 2016.

anticompetitive behavior with almost 10 percent of monopolies, a larger share than in regional peers such as Armenia, the Russian Federation, Ukraine, or Kazakhstan; and almost 70 percent of the markets have six firms or less.

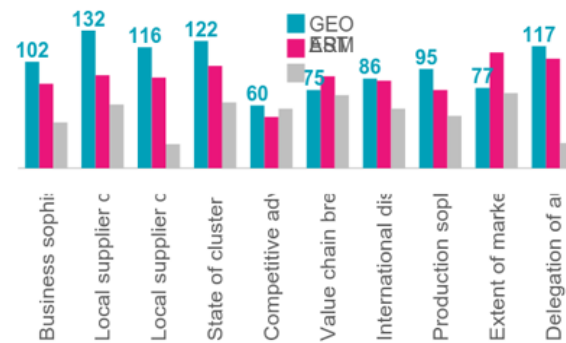
Firm Capacity and Sophistication Are Also Low

Georgian firms are still unable to produce at scale, and to high standards of quality and reliability. The most problematic factors include: (i) insufficient quantity and quality of local suppliers; (ii) limited cluster development; (iii) reliance on basic labor-intensive processes with limited use of technology; and (iv) traditional managerial practices and marketing skills. The challenges of underdeveloped supply networks and clusters, as well as the limited uptake of the latest technologies, are likely to be linked to Georgia's limited participation in global and regional value chains, and the limited inflow of efficiency-seeking FDI. Georgia's capital market is nascent and, therefore, companies do not experience market pressure to demonstrate greater corporate transparency and efficiency. Banks do not demand better corporate governance practices from their corporate borrowers, possibly as a result of their privileged position vis-à-vis other creditors in case the company falls into financial distress.

Georgian companies are characterized by limited innovation. Only 7 percent of respondents in the World Bank Entrepreneurship Survey (2012) indicated that they had introduced a new or improved product to the market, compared with two-thirds in Armenia. No products or services were new to the world in the Georgian sample, compared with 3 percent in the Armenian sample. In Georgia, the main objective of introducing a new product or service was to increase domestic sales in existing market segments, and to diversify the product mix for the domestic market. The most common area for introduction of new products or services was in methods of manufacturing, and the least common area was logistics, supply chain, and delivery or distribution methods for inputs, products, or services. Industry relevant skills are reported to be scarce, and research and development uncommon, even in high-growth firms. Only a very small share of Georgian firms has an internationally recognized quality certification—just 8 percent of Georgian firms compared with 29 percent in Estonia, 24 percent in Armenia, and 50 percent in Hungary.

FIGURE 3.9

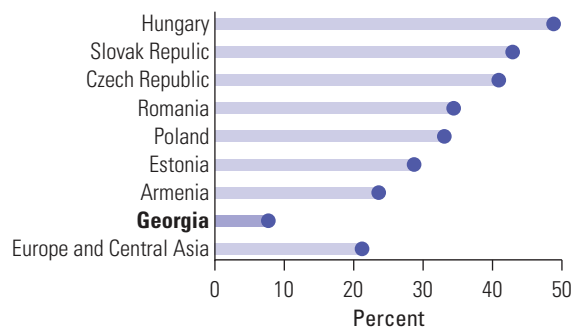
Global Competitiveness Index: Business Sophistication Pillar rank, 2016



Source: World Economic Forum.

FIGURE 3.10

Share of Firms with an Internationally-Recognized Quality Certification, 2013



Source: World Bank and the European Bank for Reconstruction and Development Business Environment and Enterprise Performance Survey.

Investment is going overwhelmingly toward 'hard infrastructure' and less so to the firm-level.

Gross fixed capital formation has been relatively high, averaging 25 percent of GDP during 2000–16. Much of this investment went to finance improvements in backbone infrastructure and services, such as roads, airports, broadband, telecom, energy generation and transmission, and financial services. Georgia was successful in attracting sizable FDI in infrastructure and the financial sector. However, investment in manufacturing has been lagging. While industry accounted for about one-third of total investment in 2007–15, this was mostly in the energy sector and comparatively less in processing sectors firms (with export potential).

Investment policy needs to be refined and re-focused on attracting efficiency-seeking investments in high value-added tradable sectors. Georgia's ability to attract and retain more export-oriented,

FIGURE 3.11

FDI by Sector, 2007–15 (US\$ million)



Source: World Bank staff calculations based on data from Geostat.

efficiency-seeking investment in higher value-added segments remains low. Therefore, it is important to refine investment policies and incentives to bring more investment into high value-added export-oriented sectors.

Removing Horizontal Productivity Constraints

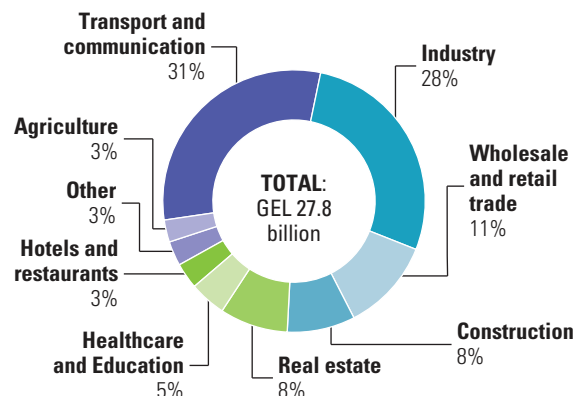
To unleash private sector growth and ensure that integration is its driving force, sector-specific policies need to be complemented by economy-wide, or horizontal, interventions. The discussion below identifies the most binding economy-wide constraints and proposes some options to alleviate them.

Hard and Soft Infrastructure: Transport and Information and Communication Technology

Georgia remains poorly connected internally and with the rest of the world, undermining its aspiration to become a regional transit hub. The Global Competitiveness Index ranks Georgia's infrastructure relatively high at 65th position, which is above that of countries at similar income levels. However, the aggregate ranking masks significant differences in quality across different types of infrastructure. While Georgia scores relatively high on quality of railroad infrastructure (35), telephone lines (46) and mobile-phone coverage (48), its air transport capacity is very low (99), the quality of air transport infrastructure is the worst in the South Caucasus (88), the quality of roads is lagging (78), and so is that of port infrastructure (71). While electricity shortages have

FIGURE 3.12

Investment in Fixed Assets, 2007–15



Source: World Bank staff calculations based on data from Geostat.

been largely addressed, there are inefficiencies in the energy system and insufficient transmission capacity for energy exchange. Internet access has been rising but rural areas are poorly connected, which is important for the competitiveness of the tourism sector (booking, advertisement, and payments, and so on).

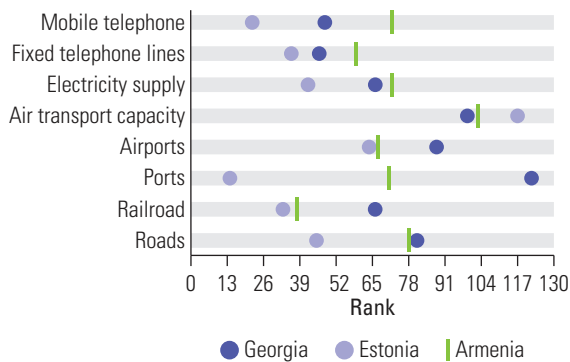
Transport

Georgia has demonstrated major achievements in improving transport connectivity, but gaps remain.

The national highway system and railway routes have expanded. There are three international airports and two international seaports/terminals. Border clearance procedures have been fundamentally streamlined. The port sector is open for private sector participation and the commercial air transport sector is fully liberalized. Nonetheless, many challenges remain, including poor quality of logistics services, insufficient capacity of major transport corridors and airports to accommodate increasing traffic, seasonal port congestion, and lagging connectivity in regions and rural areas. Further strengthening the transport infrastructure and related services will also require improvements in public investment management and new financing mechanisms.

The limited capacity of transport infrastructure, coupled with a relatively challenging geographic location, is reflected in Georgia's poor performance in the World Bank Group's Logistics Performance Index (LPI), although from a trade facilitation perspective Georgia has made important progress. Two elements determine how costly it is to bring goods to markets. First, transportation costs, driven by infrastructure and the efficiency of logistics providers. Second, policy-induced costs of moving goods

FIGURE 3.13

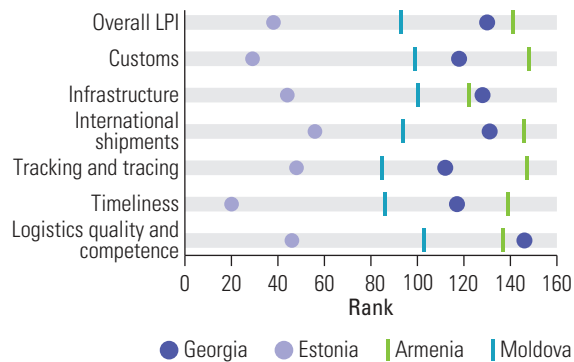
Global Competitiveness Index: Infrastructure, 2016

Source: World Economic Forum.

across the border, driven by barriers imposed at the border that include, for example, the complexity of customs procedures. The LPI is better suited to measure the first type of elements, revealing that Georgia has scope for improvement. On the competence and quality of logistics services, for example, it ranks 146. Trading partners have also stated that it is not easy to arrange competitively priced shipments (ranking 131 in this dimension), and that the trade and transport infrastructure needs improvement (ranking 128). Instead, performance indicators on policy-induced trade costs, such as the Trading Across Borders index of Doing Business, place Georgia rather better. It was ranked 54 in 2017, with time to export and import in the range of 14–15 hours—in the middle of the distribution, although still far from top performers such as Estonia or Moldova. The efforts made in facilitating trade should be coupled with improved physical infrastructure in terms of roads, ports, and logistics services.

The potential gains from past and ongoing infrastructure investment in external connectivity are often lost due to delays and high costs incurred for the movements of goods within the country. Most of the existing warehouses are characterized by poor infrastructure conditions, outdated equipment, low levels of service and extremely high storage prices. Road shipments often face delays due to frequent traffic accidents involving aged cargo trucks. Competition among many small transportation companies has driven profit margins to very low levels, preventing any one of them from renewing its fleet. The most frequent impediment identified by logistics agents is the low availability and quality of the railway rolling stock. Air cargo volumes remain modest and airport passenger capacity is becoming

FIGURE 3.14

Logistic Performance Index, 2016

Source: World Bank Group Logistics Performance Index.

insufficient to meet a rapidly increasing demand. Other bottlenecks include frequent delays at the Azerbaijan-Georgia border and the erratic operation of Caspian Sea ferries linking Baku with Aktau and Turkmenbashi.

Poor road network connectivity in regions and rural areas is a major constraint. At present, one-third of secondary and half of local road networks are in poor condition. Secondary roads are crucial for commercial agriculture to become internationally competitive, by connecting farmers to markets, but this remains a challenge. Georgia is currently allocating only half of the budget required to rehabilitate and maintain its secondary and local road networks. In parallel, the government will have to complete implementation of the ongoing modernization program for highways and railways and develop modern logistics.

Enabling private sector participation in the road sector will be important for the sector's sustainability. There is a growing financing gap to sustain investment in the road sector: around 75 percent of investment in the sector is development partner-financed and there is no private sector participation. Total government revenue related to roads and transport is one-third road expenditure (including development partners financing). Therefore, it will be important to develop and introduce financing mechanisms to sustainably finance the operation and maintenance of major commercial road corridors, such as the East-West Highway once it is completed. Given the limited fiscal space, greater private investment is an option for the maintenance of secondary and local roads, which are critical for reaping the full benefits of the East-West Highway. However, the rules of engagement with the private sector need

to be well defined to minimize potential contingent liabilities for the budget.

The institutional capacity to plan and manage infrastructure initiatives will need to be strengthened. The economic impact of public investment in infrastructure will greatly depend on the institutional capacity to prioritize, develop, and implement infrastructure projects. In the case of public-private partnerships (PPPs), in addition to putting in place the regulatory framework that appropriately balances risks between the public and private sectors, the government will need to build capacity within the public

sector to understand when certain PPP mechanisms can be used, develop PPP projects, analyze risks, and returns, bring projects to the market, and supervise them throughout implementation.

Information and Communication Technologies

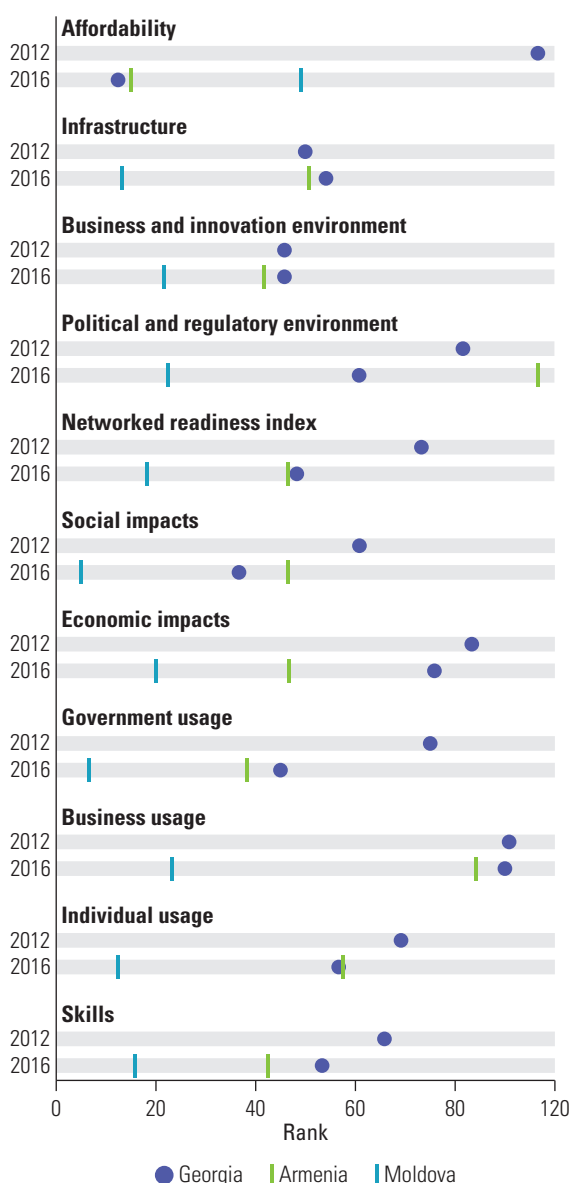
Enabling connectivity and broad use of information and communication technologies (ICTs) is a high priority, as Georgia underperforms in this important dimension of connectivity. Georgia moved up in the Global Networked Readiness Index—which rates current market conditions and the state of connectivity—from 88th position (out of 142 countries) in 2012 to 58th position (out of 139 countries) in 2016. The country has achieved remarkable progress in increasing the affordability of ICT services, moving from 101st to 15th position. Georgia has also achieved a notable expansion of ICT usage by government bodies (36 positions up), and improvements in the political and regulatory environment facilitating ICT penetration (25 positions higher). Nonetheless, Georgia underperforms in several dimensions, including mobile network coverage, international internet bandwidth and secure internet servers. Georgia has poor usage of ICT by businesses (108th, the worst-performing area) and the economic impact of ICT on competitiveness generated by technological and nontechnological innovations in the form of patents, new products, processes, and practices, is weak (91st, the second-worst area).

Georgia's broadband infrastructure coverage remains below potential. Subscription to fixed broadband services is currently at 39 percent of households, mostly in large cities. Mobile broadband subscriptions are at 38 percent of the population, the second-worst performance among benchmark countries. Currently, the internet access market is competitive, with five large private telecom companies and 2,015 licensed smaller internet service providers that have regional or community-level networks. Together, these companies have rolled out multiple cable and/or fiber optic 'backbone' and access networks, and widespread wireless networks that connect cities, regions, and smaller communities where the commercial case is viable.

Institutions: Capacity and Efficiency

In the decade following the Rose Revolution, Georgia made dramatic improvements to its regulatory and institutional environment. The country

FIGURE 3.15
Global Networked Readiness Index



Source: World Economic Forum.

achieved one of the lowest corruption levels in Europe and Central Asia, as measured by Transparency International's Corruption Perception Index. Over the past 20 years, Georgia was one of the top three countries with the most significant improvements in four out of six dimensions of the World Bank governance indicators: control of corruption, rule of law, regulatory quality, and government effectiveness. Its *Doing Business* ranking improved from 112th to 16th place out of 190 economies between 2004 and 2017.

Nonetheless, capacity varies considerably across and within institutions. Reform implementation has not been consistent across the government, with remarkable differences in administrative capacity. Government and development partners have focused on “easy-to-showcase institutions,” while others have been left out or have undergone insufficient changes. In addition, the quality of staff within institutions is uneven. While key decision-makers in the central government are generally very competent, this is less true of personnel at lower technical levels. Low capacity in local governments is also a source of concern. The population and business community report that decision-making processes at all levels are highly centralized and hence inefficient in terms of timeliness and quality.

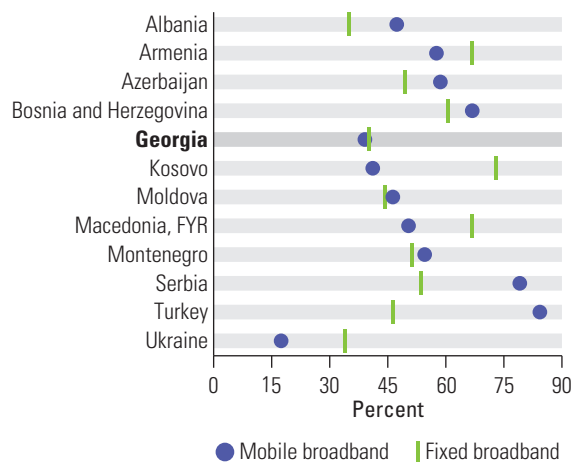
Capacity constraints and weak coordination cause serious institutional deficiencies even in areas where Georgia is doing well, such as the investment climate. These include deficient land markets, inadequate frameworks for firm exit and restructuring, insufficient investor protection and weak corporate governance (see appendix F).

Credit: Access and Diversification

The financial sector remains relatively shallow and poorly diversified. Private financial sector assets reached 101 percent of GDP in 2016 and domestic credit to the private sector increased from 9 percent of GDP in 2000 to 62 percent of GDP in 2016. However, relative to Europe and Central Asia and Organisation for Economic Co-operation and Development (OECD) averages, the financial sector remains shallow and access to finance continues to be problematic. The financial sector is dominated by the banking sector, which is well developed, with the leading banks operating at international industry standards and practices. The nonbanking sector remains largely underdeveloped, at only 9 percent of GDP, and has significant room for sophistication

FIGURE 3.16

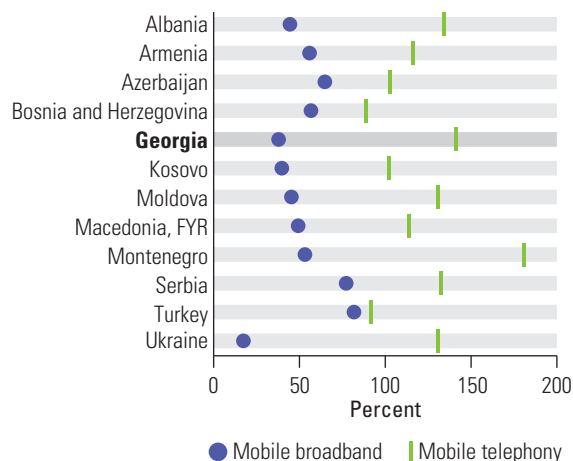
Broadband Penetration, 2016



Source: World Bank Group staff calculations based on TeleGeography Global Comms Database.

FIGURE 3.17

Mobile Telephony (Wireless) and 3/4G Mobile-Broadband Penetration, 2016



Source: World Bank Group staff calculations based on TeleGeography Global Comms Database.

improvements and growth, in terms of size, products, skills, and regulation. The capital market is also underdeveloped.

Access to credit remains a problem for SMEs. While SMEs account for about 44 percent of total employment, they generate about 20 percent of GDP and account for about 20 percent of the total volume of loans provided by banks annually. Most SMEs continue to rely on family and friends for financial resources, as they face high costs and collateral requirements, and limited offerings of customized financial products. This restricts their ability to take up profitable projects if substantial investments need

to be front-loaded. Value-chain financing, trade and assets-based financing (including leasing, factoring), preexport and export financing, and risk insurance are uncommon. The existing credit market infrastructure (pledge registry and credit reporting systems) is not used effectively to reduce lending risks to SMEs, while cumbersome business closure and insolvency procedures create significant problems for business exit and reentry. At the same time, the banks report limited SME demand for credit.

The banking sector has accumulated systemic vulnerabilities, which indirectly exacerbate access to finance problems, while undermining overall macro-financial stability. The banking sector is well capitalized, profitable, and the level of non-performing loans is not concerning. However, there are several structural vulnerabilities that need to be addressed:

- Banks rely on external and local foreign-exchange borrowing, which translates into high dollarization of assets and liabilities (figure 3.18). High dollarization increases foreign-exchange risk for borrowers and induces higher credit and refinancing risks for lenders. It also leads to significant price arbitrage and incentives for local unhedged borrowers to borrow in U.S. dollars, as the funding cost in local currency is much higher. Foreign-exchange risks of business borrowers and higher funding costs in local currency constrain the development of businesses, especially micro, small, and medium enterprises, and bring significant market and stability risks. High dollarization also undermines monetary policy transmission mechanisms and constrains the development of the interbank lending market.
- The banks' lending portfolio is concentrated

in retail lending (21 percent of GDP in 2016) and real estate on the back of rapidly increasing household leverage.

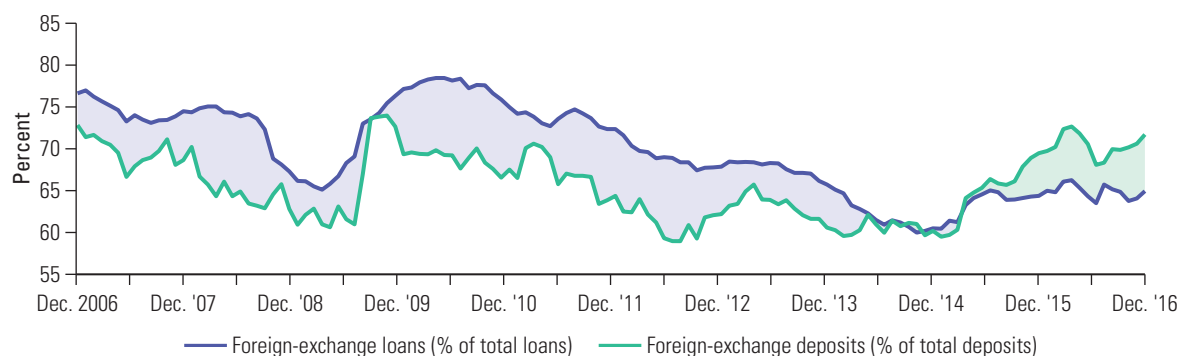
- The banking sector is highly concentrated, with the top two banks having a market share of around 70 percent. This increases systemic risks for the economy due to the large concentration and undermines effective competition.

Low domestic savings constrain financial deepening and diversification. The absence of deposit insurance and low trust in the national currency have encouraged consumption and real estate investment. High costs and capital weaknesses have severely constrained insurance sector growth and the use of insurance services, both for risk mitigation, as well as longer-term savings and social protection. Health insurance (public and private) dominates the insurance market, while other products remain nascent. Only a few companies offer agricultural insurance, while vehicle insurance is not yet mandatory (as required in the EU). Although pension insurance products are offered by the two largest insurance companies to large corporations and banks, they remain underutilized by the rest of the market due to insufficient incentives and regulation. The government expects to roll out pension reform and the introduction of contributory pension savings in mid-2018.

Capital market development will be important to diversify sources of funding for the corporate sector. The lack of institutional investors (such as pension funds) and weak corporate transparency discourage capital market development which, in turn, holds back the accumulation of domestic savings. Insurance and pension savings total less than 2 percent of GDP. Georgia does not have locally

FIGURE 3.18

Share of Foreign Currency Denominated Loans and Deposits in Banks



Source: National Bank of Georgia and IMF Financial Soundness Indicators website.

incorporated investment funds, although a handful of foreign funds, the state-owned Partnership Fund, and internationally funded equity programs are active in the country. A modern investment fund legislation and regulation is yet to be developed, along with the legislation necessary to diversify investment instruments, including corporate and asset-backed securities.

Financial sector diversification and deepening will be important to support inclusive growth. To support economic growth, job creation and household welfare, Georgia's financial sector needs to play a greater role. This will require: (i) legal reform for products development and robust market practices; (ii) effective regulation and supervision of the non-banking sector; (iii) pension, insurance and capital market reform; (iv) further development of credit market infrastructure and risk mitigation products (including partial credit guarantees, reinsurance and special products); (v) financial literacy support; and (iv) financial stability reforms (introduction of sound deposit insurance, crisis preparedness, bank resolution framework, financial consumer protection, market competition and minimization of regulatory arbitrage).

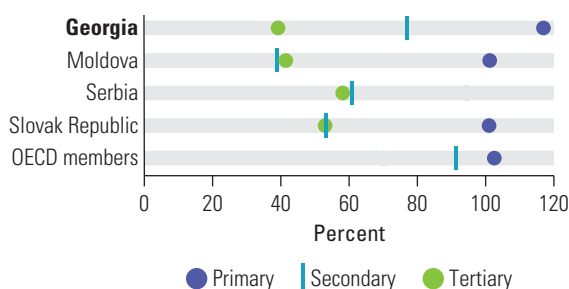
Skills and Human Capital

Georgians enjoy wide access to education, but with loose links between education and employment. Enrollment figures suggest that access to education is not a binding constraint. Even in tertiary education, Georgia has caught up in recent years: about 35 percent of the population aged 25–64 years old have completed tertiary education, which compares very well even with high-income European countries. At the same time, as many as 40 percent of Georgia's unemployed have a higher education degree.

FIGURE 3.19

Participation in Education

Gross enrollment ratio, % of relevant age group, 2015



Source: World Development Indicators

The overall poor quality of education is a major issue. Results from the 2015 PISA reveal that a majority of Georgian 15-year-old students scored below basic proficiency in core skills. These poor aggregate outcomes, moreover, hide significant variations across socioeconomic and spatial divides.

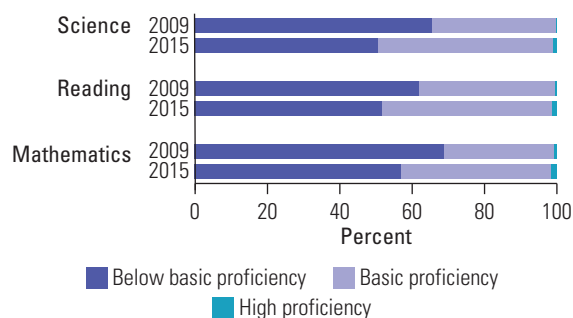
While employers flag skills as a significant constraint, the biggest gaps appear to be in soft skills that affect the learning and adaptation of potential workers. The biggest gaps that employers report is not in core technical areas, but in English, leadership, and creative thinking.

Looking forward, a growing digital skills gap risks leaving many workers without employment prospects. Skills and knowledge on how to use ICT are becoming increasingly important in day-to-day and work life. It is estimated that up to 90 percent of all jobs will require some knowledge related to ICT in the near future. One in five firms sees the lack of workers with solid digital skills as a major or severe problem that constrains their growth. At the same time, according to BEEPs (2013), a low share of Georgian firms provides training opportunities in ICT for their employees (11 percent), or allows them the time to innovate (14 percent). The situation is exacerbated by the lack of local training capacity to deliver global-standard training at scale, and there is weak interaction between employers and educators to define demand-oriented programs. The curricula of local universities, especially in science and engineering, are outdated. They lag the cutting-edge technological and ICT innovations, and relevance to job market needs.

Georgia's prospects will depend on the ability to continuously upgrade the overall quality of human capital. An existing skills gap—between the outcomes of education and the expectations of the labor market—is an important factor hindering

FIGURE 3.20

PISA Scores Reveal Major Quality Concerns, 2015

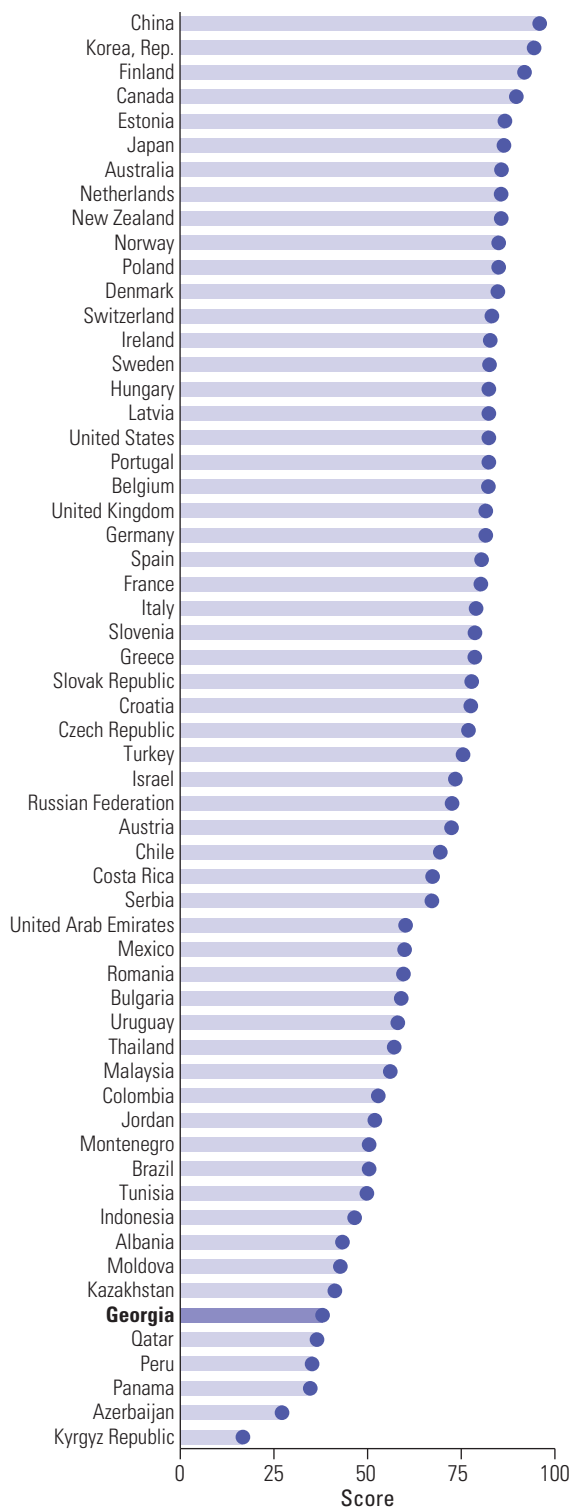


Source: OECD 2016.

employment prospects in Georgia today. Youth and non-traditional workers are often outside the immediate context for professional education and training and, therefore, at a disadvantage.

FIGURE 3.21

PISA Scores: Georgia is Lagging OECD Comparators

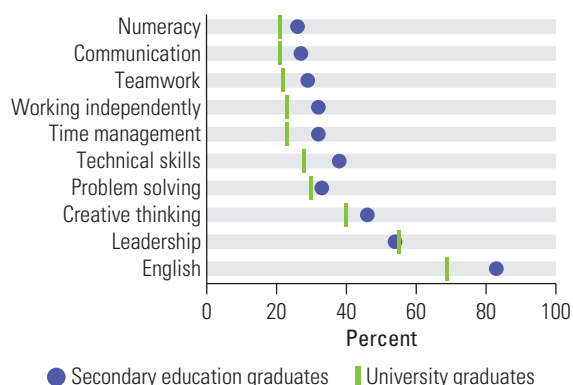


Source: OECD 2016.

Georgia's growing dependency on a shrinking labor force makes it imperative that those who enter the labor market are adequately skilled. A high-quality education is a key foundation for this, but an area of concern for the country. The most recent results from PISA show that, despite some progress, learning outcomes for secondary-aged children lag behind the OECD and European and Central Asian averages (figures 3.23 and 3.24).

FIGURE 3.22

Georgians Are Lacking Soft Skills



Source: World Bank 2012.

FIGURE 3.23

Test Scores Have Improved on Average...

PISA average test scores, 2009 and 2015

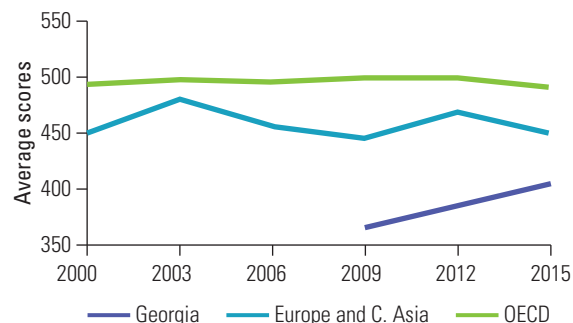


Source: OECD 2009 and 2015.

FIGURE 3.24

...But Remain below OECD and European and Central Asian Averages

PISA average test scores, 2000–15



Source: OECD 2009 and 2015.

Georgia will need to prioritize efforts to improve learning outcomes and skills creation in its education system. The system needs to be reformed at all levels, with some key priorities, such as: (i) improving teacher quality and curriculum; (ii) expanding the coverage and quality of early childhood education, particularly in rural areas and among disadvantaged population segments; and (iii) reforming the tertiary education system to strengthen the institutional side through performance-based funding, better quality assurance, and a shift in focus from inputs to results-based accountability mechanisms, together with curricular changes to ensure better alignment with skills demanded in the labor market.

Notes

1. Competitive exports are those with revealed comparative advantage equal or above 1 (Harmonized System 4-digit classification).

2. Interviews with key garment producers in Tbilisi revealed that firms heavily rely on imported inputs, including buttons, zippers, and fibers. Having easy access to these inputs has been crucial in the success of the segment.

3. Appendix D provides a more in-depth presentation of sectoral performance and prospects.

4. World Bank (2017).

5. Benmaamar, Keou, and Saslavsky (2015).

6. The affordability pillar assesses the cost of accessing information and communication technology (ICT) and the level of competition in the ICT sector that affects the cost. Improvements in ICT connectivity and affordability are reflected in several dimensions of economic activity. For example, the introduction of e-procurement systems at the government level increased the likelihood of firms bidding for government contracts. Employment search has also been facilitated by improved ICT penetration: online employment search among the employed and the unemployed is above 20 percent in urban Georgia (similar to urban Armenia), while well below 5 percent in Vietnam, Bolivia, or Ghana (World Bank 2016).

7. There were two distinctive reform phases. During 2003–07, the public administration went through major deregulation, downsizing, and anti-corruption reforms. This entailed the dissolution of all agencies, the reduction of ministries from 18 to 13, and a downsizing of civil servant staff by 50 percent. In parallel, many burdensome and discretionary regulations were abolished. Other measures included administrative simplification (for example, one-stop shops and e-government solutions), increased pay for civil servants, and customer satisfaction measurements. The second phase started in 2008, when the government was gradually forced to abandon full laissez-faire.

8. Eiweida and others (2013).

9. The two largest banks are traded on the London stock exchange.

10. Kitts and others (2015).

11. Broadband Commission, United Nations.

12. Inadequately educated workforce is identified as one of the top five obstacles for innovators in Georgia by the World Bank and the European Bank for Reconstruction and Development Business Environment and Enterprise Performance Survey.

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CHAPTER 4

PROMOTING SOCIAL AND SPATIAL INTEGRATION

Demography does not necessarily have to define Georgia's destiny, but the new population realities will demand important adjustments. Georgia's population is aging and shrinking due to low fertility and outmigration. This has important implications for spatial planning, but also for productivity and growth. Villages are shrinking, and most cities are stagnating. In the former, most residents live from subsistence farming and transfers, contributing little to the economy. In the latter, the potential for agglomeration benefits and scale economies is depressed.

Findings

- Georgia's population is aging and shrinking, due to low fertility and outmigration. It will not be possible to counter this trend in the medium-term unless Georgia attracts immigrants.
- Too few Georgians are formal wage workers. Out of a population of 3.7 million, only 700,000 are formally employed, one-third of which in the public sector. Women and rural Georgians are the least likely to have formal jobs.
- Georgia's lack of social dynamism is reinforced by spatial inequality. However, while living conditions are better in urban areas, urban dynamism and job opportunities are insufficient to "pull" people to move to urban areas.

Recommendations

- Equalize access to opportunities, through spatially-targeted approaches to reduce the gaps in access to quality education and health and maximize the creation and deployment of scarce human capital.
- Address constraints to spatial mobility (from rural to urban areas) and economic spillovers (from urban to rural areas) in parallel with sector specific interventions to revitalize economic sectors that can support productive rural employment (for example, tourism and commercial agriculture).
- Create formal wage jobs and promote transitions into the labor force, especially for women in unpaid jobs in rural areas, and unemployed young women who are also not in education or training.
- To close the skills gap, Georgia could consider a well-crafted policy to promote immigration to attract its diaspora and foreign nationals.

Beso Idoidze is the only living soul guarding the historical, highland village of Dartlo through the long and forbidding Tushetian winters. Situated 2,000 meters above sea level, the village is often cut-off from the outside world from late September until the end of April. However, it takes more than frost and harsh winds to make Beso abandon his vigil. As long as he has some wood to burn and essential food items such as potatoes, sugar, flour, and olive oil in his larder, he perseveres every winter.

Tourism is the only source of income for Dartlo's residents. Some own guesthouses, others produce traditional handicrafts, and those who have horses offer riding tours. Some are also involved in restoration work to maintain the local architecture of this unique village. Unfortunately, the tourism season is short: in good years it may stay open for four months, from early June to mid-October. This is the reason why many people living in highland villages such as Dartlo prefer to relocate to towns, or to the capital, bringing them closer to jobs. The number of residents in Dartlo and neighboring villages has been shrinking over the years, leaving only elders like Beso holding the fort.



In order to sustain economic growth, Georgia faces a double inclusion challenge: including youth into the labor force and also rural areas into the productive economy. Given Georgia's demographic realities, a defining challenge for the future is to ensure that more Georgians work in formal wage occupations, including specifically youth and rural populations.

Although it is an emerging middle-income country, Georgia is still not quite a middle-class society. There is a sizable degree of vulnerability in the population: two in five Georgians have income levels and characteristics that place them at real risk of falling back into poverty. Part of the reason for this vulnerability is an overwhelming reliance on informal, low-productivity activities.

Helping Georgians to secure higher and more stable incomes will require interventions on the demand and supply sides: not only facilitating private-sector led job growth, but also leveling the opportunities playing field, so that all citizens can bolster their stock of human capital (through quality education and health), and intensively use it in the labor market. Improving education quality across the board, and eliminating the social, economic, and structural/spatial barriers to education and employment opportunities are key elements of a strategy to enhance the labor productivity and participation of Georgians in the economy.

The Demographic Challenge

Georgia's population is declining, and so is the size of the working age population. Georgia's population peaked in the early 1990s and has declined sharply ever since. In 2015, the population headcount stood at just 3.7 million people, the level it had 50 years ago. Moreover, the decline was relatively faster among those of working age and children, while the elderly population is growing slightly.

The driving force behind these trends is declining fertility. At the time of independence, the total fertility rate stood at the replacement level of 2.1 children per woman. Post-transition, fertility declined until 2002, when it reached 1.6 births per woman. There was a modest recovery in subsequent years and the fertility rate has now stabilized at 1.8 births per woman.

Out-migration has compounded low fertility. In the early 1990s, many non-Georgians permanently left the country, and ethnic Georgians—many of them high-skilled—also emigrated. Sluggish eco-

nomics growth between 1996 and 2004 meant that many continued to look for opportunities elsewhere—either permanently or temporarily. The Russian Federation has been the primary destination, although Georgians also migrated to countries in Western Europe, as well as the United States. Available estimates suggest that more than 10 percent of the total population left the country between 2000 and 2010.

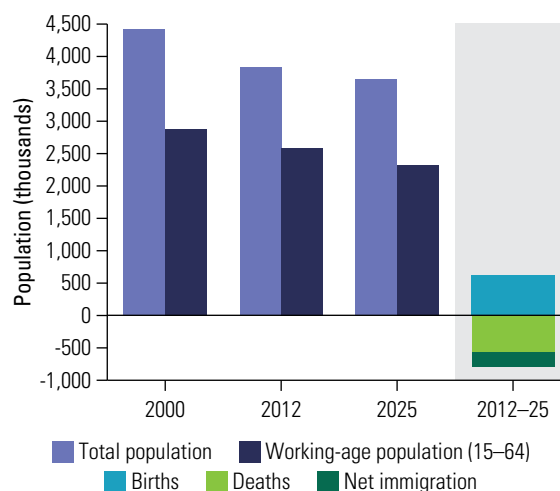
Current population projections suggest that Georgia's population will continue to decline (figure 4.1). These demographic trends pose a significant challenge to Georgia's economic future as they erode the size of the country's already small working age population and constrain the potential to reap agglomeration and scale effects.

To keep the working age population from declining, Georgia will need to attract new workers. Specifically, a net migration equivalent of 2.5 percent of the total population per year will be required to keep the working-age population from declining. Without such immigration, the working-age population of Georgia is projected to decline from 67 percent in 2015 to 60 percent by 2050 and the dependency ratio—a measure of the economic pressure on the productive population to support children and the elderly—will increase by 10 percentage points by 2025. Encouraging immigration at a rate of over 40,000 workers per year for the next 10 years would ease that pressure by keeping the dependency ratio at its 2012 level (figure 4.2).

FIGURE 4.1

Georgia's Population Will Keep Declining in the Future

Population and components of difference, 2000, 2012, and 2025



Source: World Bank staff calculations based on data from the World Development Indicators.

Although reversing the profile of migration flows in a short period of time is not often observed, it is possible. For example, Kazakhstan entered the new century experiencing large net emigration, but then shifted to being a net receiver of migrants, as workers responded to an improving economy and declining unemployment. For Georgia, a key challenge and opportunity will be to convince its youth to remain in the country and to encourage return migration, especially of high-skilled Georgians abroad (box 4.1).

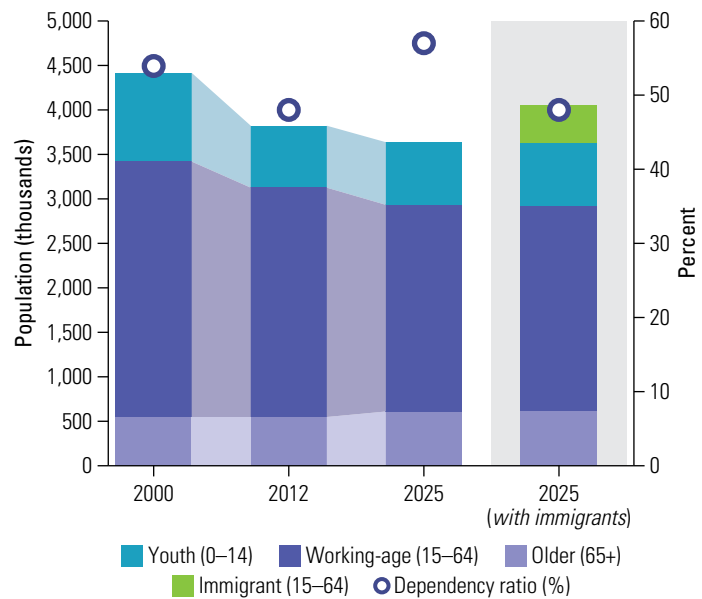
Maximizing Labor Force Participation

Too few Georgians have formal jobs. Less than a 20 percent of Georgians—only 700,000 people—are wage workers. This is only one-third of the working age population and explains why the country has not yet fully transformed into a modern economy, especially as more than one-third of these wage workers are employed in the public sector. Conversely, a large share of the population is either out of the labor force

FIGURE 4.2

Keeping the Same Dependency Ratio as in 2012 Will Require More Immigrants Aged 15–64

Population by age group and dependency ratio, 2000, 2012, and 2025



Source: World Bank staff calculations based on World Development Indicators.

BOX 4.1

Successful Examples of Attracting Skilled Migrants

1. Chile: “Start-up Chile”

The Chilean government launched a pilot program in 2010. The aim of “Start-Up Chile” is to attract early-stage, high-potential entrepreneurs worldwide. The ultimate objective of this scheme is to position Chile as the innovation and entrepreneurship hub of Latin America. The program runs like a competition for funding, with three competitions each year. Each competition results in the selection of 100 start-ups with on average two founders per start-up. The scheme selects promising young firms and gives their founders capital, space networking mentoring, and a year’s visa to come and work on their ideas in Chile. Chile also has one of the fastest incorporation rates in the world, allowing a new start-up to incorporate almost in one day. Since its introduction, around 500 companies and almost 900 entrepreneurs from a total of 37 countries have benefited from it. Start-Up Chile has attracted a lot of global high-tech companies. In addition, the influx of start-ups is boosting local interest in entrepreneurship. The introduction of the Start-Up Chile has also changed Chileans’ attitudes and provided them with a global network of business contacts.

2. Singapore: Entrepass

Singapore Entrepass was created in 2004. It went through several updates to better target innovative entrepreneurs. The scheme is part of Singapore’s general plan to become a regional business hub and attract the best entrepreneurial minds to the

country. The business must satisfy the ‘innovativeness’ requirement which was introduced in September 2013. In selected cases for particularly promising businesses, the government will match investment from the private sector. The visa is granted for one year and renewal criteria are based on progressive targets for local job creation, revenues, and spending. The EntrePass allows the applicant to bring family members (spouse and unmarried children under 21) to Singapore by applying for their Dependant’s Passes. EntrePass holders are also eligible to apply for Singapore permanent residence. There is no official quota of the number of EntrePass to be granted. In 2012, there were 1,300 EntrePass visa applications and 1,000 applications in 2013, 50 percent of which were accepted.

3. Portugal: Golden Visa

The Portugal Golden Visa program has proven to be the most popular scheme in Europe with investors attracted to its flexibility and benefits. Launched in 2012, the investor visa program has been actively promoted internationally by the. An investment of €500,000 in real estate in Portugal will gain a residency permit for a family including dependent children. This program has proven to be hugely popular and has contributed to economic growth in Portugal since the scheme was launched. House prices have risen significantly, and many investors are already noticing the potential in future capital gains.

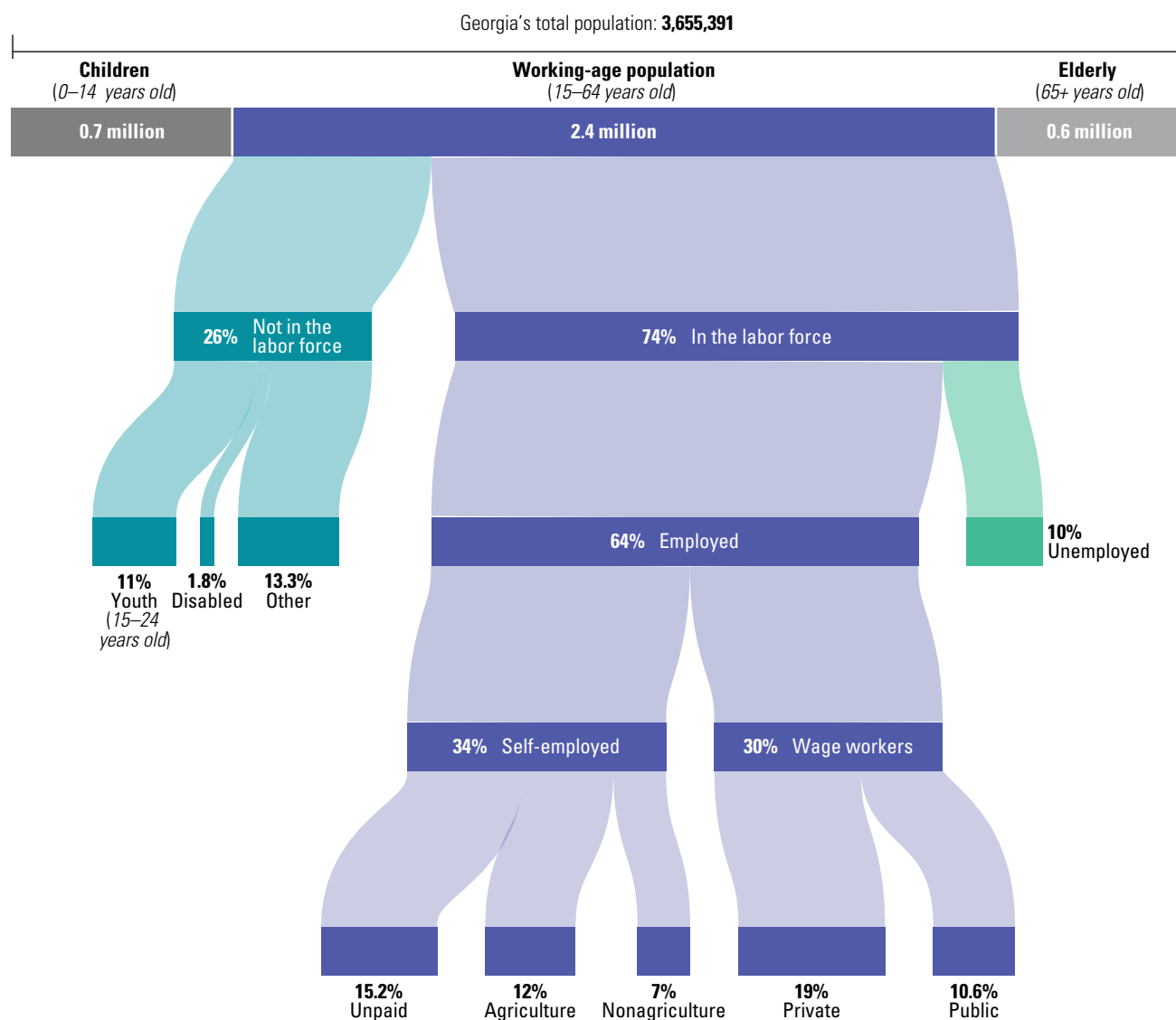
(26 percent), unemployed (10 percent), or underemployed (35 percent), often in low-productivity agriculture (figure 4.3).

One way of increasing overall labor force participation is by bringing in more women. Female labor participation—at about 58 percent—is about average for the region and slightly above that of Eastern European countries. But it could be increased and better allocated. Women’s lagging participation in employment and entrepreneurship can be readily recognized as a misallocation of Georgia’s human resource potential, with gaps resulting in an estimated loss of economic output equivalent to 11 percent of gross domestic product (GDP). In countries such as Iceland and the United States, where female

labor force participation stands at around 70 percent, the estimated income loss is consequently lower. The gender gap in labor force participation has remain largely unchanged since 2008 at almost 20 percentage points, just under the average for the region or that of upper middle-income countries, but three times larger than in Slovenia, Latvia, or Lithuania. Compared with these countries, Georgia provides lower levels of support to household with responsibilities such as childcare and eldercare, which plays an important role in reducing female labor force participation. The negative association between women’s labor force participation and childcare responsibilities is large enough to cancel-out the positive impact of more education on women’s labor activity.

FIGURE 4.3

Many Georgians Are Unemployed or Working in Low-Productivity Activities

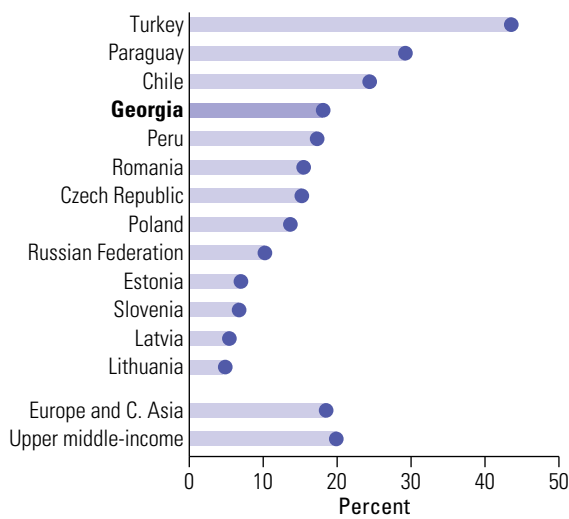


Source: World Bank staff calculations based on IHS 2015, 2016, and 2017 data (Geostat).

FIGURE 4.4

Georgia's Gender Gap in Labor Force Participation Remains Substantial

Georgia and selected countries, 2017



Source: Calculations based on World Bank 2017 (figure 3.6).

Activating the youth is equally important. Labor force participation among Georgia's youth is low, but comparable to that of other advanced reformers, such as Lithuania, or Slovenia. But unlike these countries, where the proportion of youth not in employment, education, or training (NEET) is less than 10 percent—which means that many unemployed youth are actually enrolled in education or training—the equivalent share in Georgia is 30 percent, with higher levels for young women. Low rates of overall labor force participation and a relatively high proportion of NEETs suggest that Georgia's youth may be disproportionately at risk of labor market exclusion. Since the NEETs are neither investing in skills nor gaining experience through employment, they have limited chances of finding (productive) employment in the future.

Stalled Structural and Spatial Transformation

A sizable share of the population remains engaged in very low-productivity activities in the rural economy. Over the past decade, employment in agriculture has declined by less than 1 percentage point annually and still stands at 49 percent nationwide (71 percent in rural areas), while it contributes only just over 8 percent of total value-added in the economy. Although there is some commercial activity, including in high-end niche products such as wine, most agricultural activities remain of a subsistence

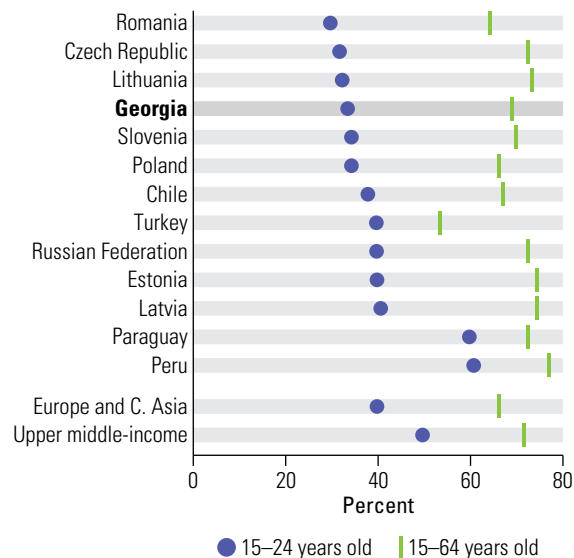
nature. Indeed, close to three-quarters of households engaged in agricultural production report producing mainly for their own consumption. Economic activities outside the agriculture sector in rural areas are very limited, which implies that a large segment of the economically active population is highly unproductive.

Rural employment is mostly informal. About 43 percent of those employed nationwide work in wage

FIGURE 4.5

Labor Force Participation

By age group, Georgia and selected countries, 2017

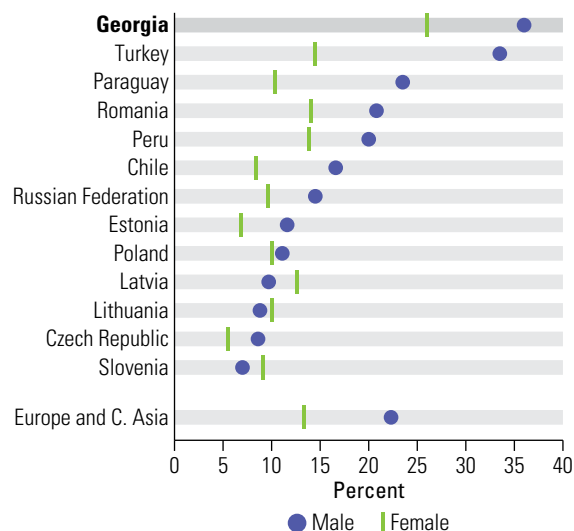


Source: Calculations using data from the World Development Indicators and International Labour Organization estimate.

FIGURE 4.6

Youth Not in Employment, Education, or Training

Georgia and Selected Countries, 2017



Source: Calculations using data from the World Development Indicators and ETF 2015 based on World Bank 2017 (figure 3.6).

jobs mostly in Tbilisi and other urban areas. Among the remaining 57 percent, 42 percent are engaged in agriculture, either as own-account workers (24 percent) or unpaid workers (23 percent). The bulk of unpaid work (95 percent) is in rural areas and carried out by women (69 percent), and when paid, almost the totality of workers in the sector work as own-account workers. The remaining 15 percent of nonwage workers are self-employed outside of the agriculture sector.

Given the high urban/rural and formal/informal productivity differentials, limited spatial and structural transformation and low urbanization are constraining growth. As in many other countries, growth centers in Georgia are highly polarized, with most economic activity concentrated in Tbilisi and Batumi. The capital hosts about one-third of the national population and accounts for half of the country's GDP. Its per capita output is nearly twice the national average, and more than three times that of the most lagging regions. Living standards are much higher in urban areas and access to opportunities are better. The fact that Tbilisi and Adjara are the only two regions that have seen positive urban population growth between 2002 and 2014 demonstrates that these poles have succeeded in attracting people, but the strength of the pull remains weak. The urban population in Tbilisi and Adjara increased by a cumulative 2.5 percent and 11 percent, respectively, between these two census rounds (table 4.1).

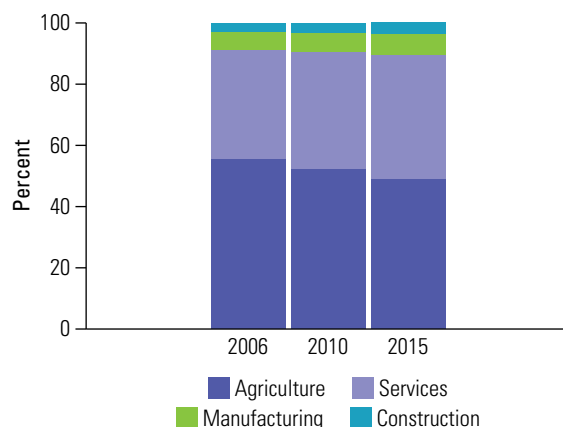
The slow growth of urban areas reflects a combination of limited opportunities and structural constraints to internal mobility. Available evidence

suggests that there is a substantial amount of internal migration, at least across regions, given that about 28.5 percent of the population report living in a location different from their places of birth. Tbilisi is the largest net receiver of population, but there is also a sizable outflow from Tbilisi to other parts of the country. Getting a better understanding of who moves, for what reasons, and for what duration, and of how these moves square with observed patterns of regional and city growth, is as an important knowledge agenda that should be addressed beyond this Systematic Country Diagnostic. However, what emerges clearly is that weaknesses in the land market make this crucial asset hard to collateralize and turn into capital. In certain rural areas, with aging and shrinking populations, depressed land prices, act as a disincentive for migration to more expensive urban areas. Limited educational attainment (only 15 percent of rural population have higher education), and still insufficient employment creation in urban centers also act as deterrents. Despite a continuous reduction in urban unemployment since 2008, it was still above 20 percent in 2016.

Georgia will need to rethink its spatial development policy, to better deploy its limited resources. The provision of basic services and infrastructure, together with efforts to enable people to move to the cities, will help the country to achieve more inclusive growth. It will also positively impact environmental concerns on air pollution. However, Georgia could soon witness “dying villages” (the share of households with only elderly members is over 15 percent in rural areas). With limited resources, the government

FIGURE 4.7
Employment Distribution

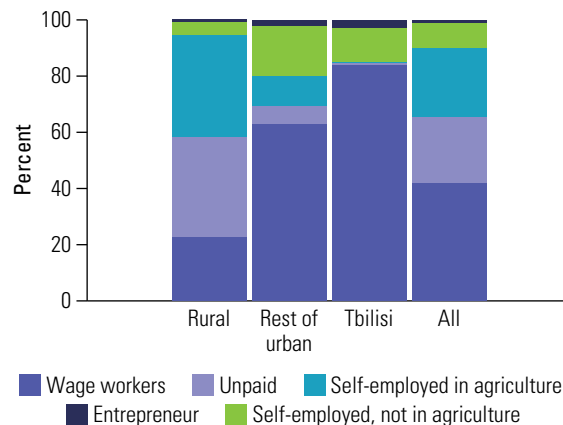
By Main Sectors, 2006, 2010, and 2015



Source: World Bank staff calculations based on data from the IHS (Geostat).

FIGURE 4.8
Type of Work

By Place of Residence, 2015



Source: World Bank staff calculations based on data from the IHS (Geostat).

TABLE 4.1

Overall Population and Urban Population

By Region, 2002 and 2014

	2014		2002		Overall population	Urban population
	Total	Urban	Total	Urban		
Georgia	3,713,804	2,122,623	4,369,579	2,285,290	Down	Down
Tbilisi	1,108,717	1,078,297	1,081,679	1,052,001	Up	Up
Adjara	333,953	184,774	376,016	166,575	Down	Up
Guria	113,350	31,904	143,357	37,560	Down	Down
Imereti	533,906	258,510	699,666	323,945	Down	Down
Kakheti	318,583	71,526	407,182	84,694	Down	Down
Mtaketa-Mtianeti	94,573	21,259	125,443	32,113	Down	Down
Racha-Lechkhumi and Kvemo Svaneti	32,089	6,970	50,969	9,582	Down	Down
Samegrelo-Zemo Svaneti	330,761	129,391	466,100	183,177	Down	Down
Samatkhe-Javakheti	160,504	54,663	207,598	65,601	Down	Down
Kvemo Kartli	423,986	180,118	497,530	186,574	Down	Down
Shida Kartli	263,382	105,211	314,039	113,682	Down	Down

Source: Population Census 2002 and 2014.

Note: The population of Abkhazia has been excluded from the 2002 total to make it comparable to 2014.

faces a choice between providing services to these small and shrinking remote establishments on the one hand, and supporting the requirements of increasing urbanization on the other.

Further removing constraints to spatial mobility, including by improving connectivity, would help to unlock under-leveraged growth engines in agriculture and tourism, and also address territorial inequalities. Recent evidence suggests that urban growth, in Tbilisi and other cities, does not easily spill over into rural areas, consistent with the close to 20 percent of rural households that depend entirely on self-production of food and social assistance. Geographically uneven development and the persistence of territorial inequalities are not particularly unique to Georgia, although its unique topography that includes remote and mountainous regions, along with fertile valleys and seashores, gives it a particular character. However, the lack of economic connectivity between urban and rural areas undermines sustainable improvement in living standards in rural areas, either in agriculture through links with agricultural value chains, or in nonagricultural activities, such as tourism.

Notes

1. Cuberes and Teignier (2016).
2. World Bank Country Gender Assessment.

3. According to a recent census-based report, while the percentage of males who are neither in employment or education drops to 31 percent at age 29, the percentage of females continues to rise to 54 percent (Eelens 2017). A possible explanation of the high number of female youth not in employment, education, or training is the long-standing and still prevalent tradition of early marriage and early childbearing among some groups in Georgia.

4. World Bank (2017).
5. World Bank (2017).
6. From first-hand consultations, as well as available research.
7. Sinha and others (2016).

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CHAPTER 5

MANAGING RISKS FOR SUSTAINABLE GROWTH

Georgia's ability to extend progress into the future hinges on the way it preserves two of its great assets: a tradition of prudent macroeconomic management and its unique environment; both of which are under strain. In recent years, Georgia has relaxed its traditionally prudent fiscal stance: increases in expenditure and spending commitments have widened the structural deficit and weakened debt sustainability. Consequently, maintaining fiscal sustainability, while supporting growth and social safety nets, will become increasingly important. The environment is also under stress, and the potential for Georgia to leverage the wealth of its natural resources could come into conflict with the need to preserve it.



Findings

- The introduction of universal health care (UHC), tax reform, and planned increases in capital spending have heightened concerns over fiscal sustainability.
- Georgia has the world's highest mortality rate due to air pollution.



Recommendations

- Georgia needs to increase the efficiency and effectiveness of public investment, including through better public procurement practices.
- Off-budget operations and contingent liabilities are a significant source of fiscal risk, which needs proactive management.
- Protecting the environment is critical to further develop the tourism sector, one of Georgia's fastest growing services exports.

Maia Kiknadze established “Caucasus Travel,” Georgia’s very first tour operator in 1991. This was at a time when the country had no tourist infrastructure whatsoever, and no compliance with international standards. There was almost no international awareness of the country—Georgia was identified either as a province of the former Soviet Union or one of the states in the United States. Several years later, Caucasus Travel has grown and spawned additional companies that have been united under the banner of one holding company, the Georgian Hospitality Group, which in total has 60 full-time employees. Maia says she believes that the company has played a significant role in raising awareness about Georgia and creating its tourism industry. Overall, the major tourist product that Georgia has to offer to the world is cultural tourism, which is then combined with wine and gourmet tourism, adventure, eco and so-called “nature-based” tourism. It is around these major products that tourism-market offers are generally oriented.



Fiscal Space Is Increasingly Constrained

Georgia had previously maintained a countercyclical fiscal policy stance, which allowed public debt to remain within sustainable margins. During the high growth rate period of 2004–07, the tax regime was streamlined with reductions in the number of taxes and key tax rates. Increases in tax revenues—from 14.6 percent of gross domestic product (GDP) in 2003 to 25.8 percent in 2007—stemmed mostly from parallel initiatives to strengthen tax administration. While spending increased even faster, raising the fiscal deficit, privatization receipts allowed public debt to fall from 55 percent to 22 percent of GDP during the period. Following the twin shocks in 2008 and the subsequent sharp economic contraction, the authorities responded with a fiscal stimulus program that increased the deficit and raised debt levels, but supported the recovery. As the economy rebounded, expenditure-driven fiscal consolidation followed during 2010–11.

Fiscal discipline was relaxed following the change in government in 2012. Spending increased significantly as the new administration prioritized social policies and sought to respond to the external shock of late 2014. As a result, the fiscal deficit has widened since 2015: it reached 3.9 and 3.8 percent of GDP in 2016 and 2017 respectively, while the public debt-to-GDP ratio rose to 44 percent as of end-2017 compared to 33 percent of GDP in 2012. (figure 5.1).

Increases in social spending and new entitlements widened the structural deficit. The

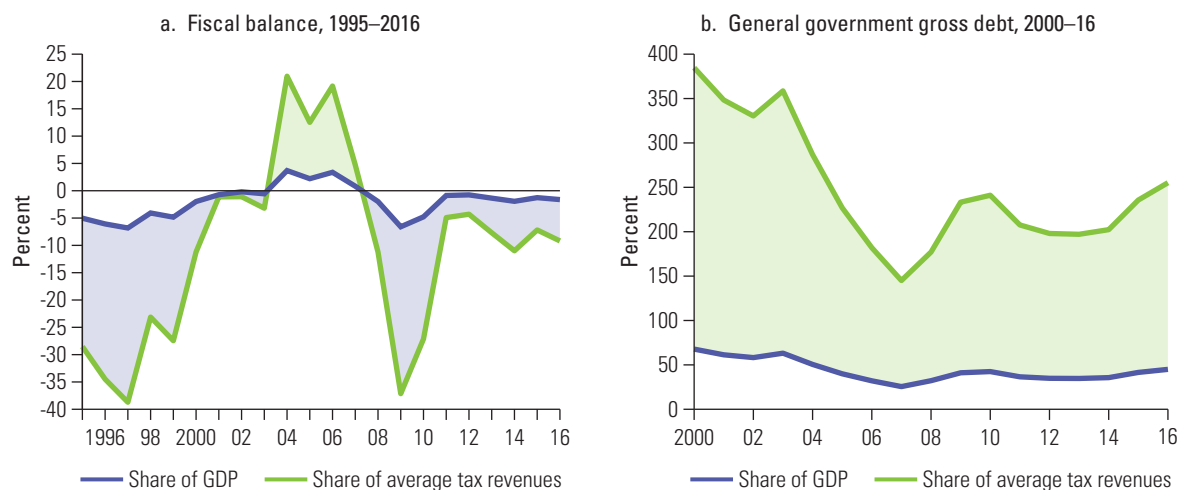
government reoriented its spending priorities to address social needs, and this has resulted in an increase in social spending from 7 percent of GDP in 2012 to 9.3 percent in 2017. The increases were primarily in the public sector wage bill, the level of pensions, health (following the introduction of UHC), electricity subsidies, and incentives provided under the High Mountainous Regions Law. This reorientation has made the budget more rigid and shifted the balance of spending toward recurrent expenditures.

Overruns in health spending have highlighted a specific challenge the government faces in maintaining the sustainability of the UHC program. Since the implementation of UHC, health spending has risen sharply (from 4.0 percent to 8.4 percent of total government spending between 2012 and 2017), and UHC spending has overshot its budgeted amount in 2015 and 2016 before stabilizing in 2017. While public health spending remains low—at 2.3 percent of GDP—and out-of-pocket expenditures place a significant burden on households, the macrofiscal outlook can hardly accommodate further increases in health spending in the short to medium-term in the absence of compensating adjustments to overall system efficiency.

Planned increases in capital spending may add further pressure on fiscal balances in the medium-term. Public capital expenditures have declined in recent years, from 8–9 percent of GDP during 2007–12 to 6.3 percent of GDP in 2013–16. Most of the capital expenditures are in the areas of roads, municipal infrastructure, tourism-related infrastructure,

FIGURE 5.1

Fiscal Imbalances Have Widened and Their Sustainability Worsened



Source: Kose and others 2017.

housing for IDPs, and hydropower rehabilitation and transmission. Going forward, however, the government plans to significantly ramp up capital spending over the medium-term. In 2017, the share of the investment budget in the total fiscal envelope increased to almost 20 percent by 2.1 percentage points.

Changes in the corporate tax regime and contingent liabilities have added to fiscal concerns. Early in 2017, the government introduced the Estonian tax model, replacing the corporate income tax with a dividend tax: from 2017 onward, only distributed profits are taxed at the existing rate of 15 percent. This measure is expected to boost growth in the medium-term, but proceeds from this type of tax declined in 2017. To compensate for the revenue loss, excises on fuel, tobacco and cars were increased. Other instruments are difficult to adjust, as the Liberty Act—which supports the stability of the tax system—requires a referendum to introduce new taxes or increase rates, with the exception of excise and property taxes. Hence, further fiscal adjustment will need to come from lower expenditures. Contingent liabilities are also a concern. The government has signed power purchase agreements with several hydropower companies, which could have large fiscal implications going forward. In addition, the SOE sector is a potential source of major contingent liabilities. Some estimates put these contingent liabilities at about 40 percent of GDP.

In order to return to a more sustainable path, the government developed a fiscal consolidation program at the end of 2016. The program was reflected in the annual State Budgets for 2017 and 2018 and the government's medium-term framework, which envisages the deficit being reduced gradually to 2.4 percent of GDP by 2022. This rests on the successful implementation of a set of ambitious targets to: (i) reap efficiency gains in current spending; (ii) restrict the management of the wage bill at central and local level of the government; and (iii) additional spending controls on local governments for the purchase of goods and services. (iv) in public health care the aim is to place more emphasis on the most vulnerable and generally improve the management of claims; (v) improve management of public investment projects through introduction and implementation of PIM guidelines at the central and local budget level; (vi) reduce fiscal and quasi-fiscal risks through monitoring of contingent liabilities and enactment of the new PPP law. Meanwhile

the revenue performance has been continuously robust and the revenue shortage risks associated with the elimination of profit taxes on reinvested profits (Estonian model), has been minimized by a sharp increase in excise tax rates on fuel and tobacco, especially from 2017.

The recent developments in 2017 were positive overall. Growth was estimated to have recovered significantly, driven by strong credit growth and a sharp recovery in remittances. Exports also recovered by over 20 percent year-on-year, net exports contributed positively to growth along with favorable tourism and remittances dynamics. The fiscal accounts were consistent with the announced consolidation policy, which envisaged a flat current spending envelope and a spike in capital investments. Tax collections increased, mostly from excise and VAT on the back of stronger than expected economic activity. As a result, the overall fiscal balance in 2017 was maintained below 4 percent. The outlook for 2018 is also favorable: the 2018 budget law sustains fiscal consolidation while providing more space for capital spending.

Nonetheless, going forward, maintaining fiscal sustainability while supporting growth will require continued disciplined focus.

- The Liberty Act restrains the government from introducing new taxes or increasing tax rates, with a few exceptions, putting the burden of adjustment squarely on the expenditure side.
- To address significant infrastructure needs and boost competitiveness, spending increases will also require greater emphasis on investment quality. Since 2010, digital government procurement (e-GP) has fully replaced the former paper-based procurement system, making the public procurement process simpler and more transparent, with enhanced competition and reduced scope for corruption. In 2016, a new public investment management framework was adopted. The government is also finalizing a legal and regulatory framework to guide PPPs in infrastructure projects. All these efforts will help to improve the efficiency and effectiveness of public investment, but further advances will be needed.
- Planned increases in capital spending, which can help boost long-term growth, will require the government to curtail current spending to remain on track toward fiscal consolidation and lower external vulnerabilities.

- Pressures have increased with new social assistance entitlements. Ensuring that these do not create disincentives for work and factoring in the impact of aging on pension liabilities will be challenging.

Moreover, contingent liabilities are cause for concern. Contingent liabilities arising from quasi-fiscal activities of SOEs and power purchase agreements with hydropower companies are imperfectly known and factored in a comprehensive analysis of fiscal risks. Going forward, these will need to be monitored and managed steadfastly to avoid the development of additional liabilities on the budget, including through establishing a comprehensive financial database for SOEs (which, according to some estimates contributed to 7 percent of GDP in 2012) and developing an analysis of fiscal risks through expanded coverage of SOEs and PPPs.

External debt is a source of vulnerability. The high reliance on foreign savings to fuel growth and the recent depreciation of the lari resulted in an increase in external debt to 112 percent of GDP by September 2017 (figure 5.2). About 75 percent of external debt is long-term and the private sector holds nearly two-thirds of external debt (figure 5.3). Inter-company external loans amount to nearly 20 percent of GDP, and generally carry lower repayment risks. In addition, 5 percent of the external debt is denominated in local currency. The main holders of Georgia's private

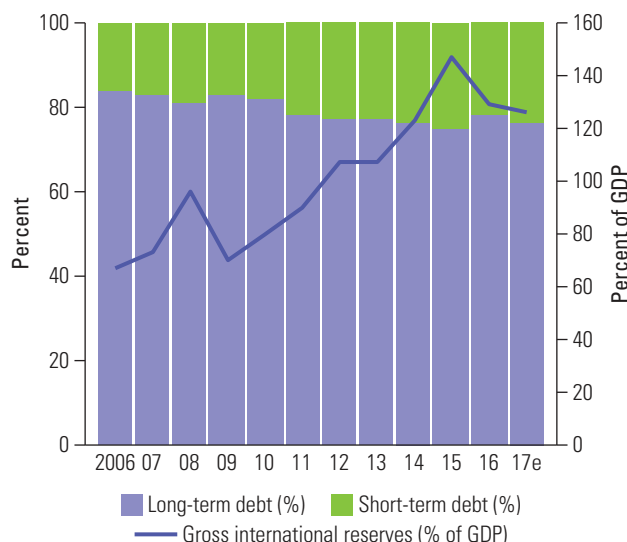
external debt include financial institutions [Bank of Georgia and Tbilisi Business Centre Bank] and non-financial corporations, such as the Georgian Oil and Gas Corporation (eurobond of US\$200 million), the Georgian Railways (eurobond of US\$670 million), and the Marabda-Kartsakhi Railway (US\$560 million highly concessional loan from Azerbaijan). Total external debt is projected to increase gradually to 87 percent of GDP by 2022 (figure 5.4). However, projections remain highly sensitive to changes in macroeconomic assumptions. According to the latest debt sustainability analysis, lower growth, and real interest rate shocks would push external debt to 95 percent and 89 percent of GDP, respectively, and a combined shock to 98 percent of GDP by 2022. A 30 percent exchange rate depreciation shock would push the debt close to 131 percent of GDP by 2022.

Environmental Concerns Need to Be Factored In

Efforts toward green growth have received a boost from the Association Agreement (AA) with the European Union and the Paris Climate Agreement of 2015. Georgia is expected to meet its environmental obligations under the AA during 2017–30. Also, under the Paris Climate Agreement, Georgia has agreed to an unconditional contribution to reduce its greenhouse gas emissions by 15 percent below the 'business-as-usual' scenario by 2030. Under the

FIGURE 5.2

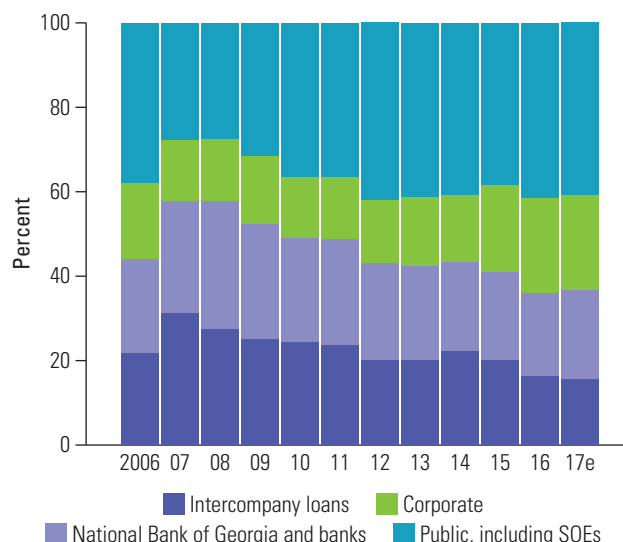
Maturity of External Debt, 2006–17



Source: National Bank of Georgia.
Note: E = estimate.

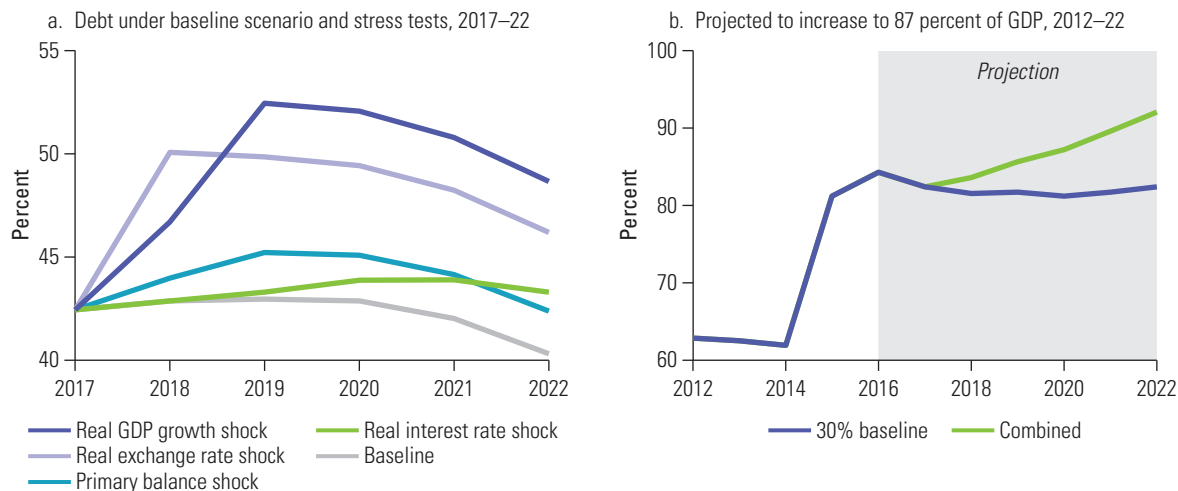
FIGURE 5.3

Composition of External Debt, 2006–17



Source: National Bank of Georgia.
Note: E = estimate; SOE = state-owned enterprise.

FIGURE 5.4

Sustainability of Total External Debt

Source: World Bank-International Monetary Fund Debt Sustainability Analysis.

Sustainable Development Goals, the government has prioritized environmental sustainability actions, such as the sustainable management of forests, and the integration of climate change mitigation and adaptation measures into national policies. Air pollution, inadequate waste management, and forest degradation due to illegal logging are the main environmental concerns, the latter leading to a higher frequency of natural disasters such as floods. Efforts toward addressing these concerns are already evident. The Waste Management Code was adopted in 2015 and the Law on Living Modified Organisms was adopted in 2014. In addition, the new Forest Code, the Environmental Assessment Code, the Law on Water Resources Management, the Law on Biological Diversity, the Law on Environmental Liability, the Law on Major Accident Prevention, the Law on Soil Protection, and amendments to the Law on Ambient Air Protection are in the pipeline and at various stages of completion.

Georgia has the world's highest mortality rate due to outdoor and indoor air pollution. Based on 2012 data, Georgia tops the country list with nearly 300 deaths per 100,000 people annually. In Tbilisi, air pollution is higher in the winter than in the summer, suggesting that, together with automobile emissions and construction work, urban heating is also a major contributor. Limited spatial and urban planning, inadequate norms on energy use in new construction, aged energy inefficient infrastructure built in pre-independence years, the absence of technical inspections of vehicles, and high sulfur levels

in gasoline, are partly responsible for this high level of deaths. Hard-fuel burning generates significant indoor pollution, which is localized and seasonal, but may be a significant health hazard to those exposed.

Georgia's ecosystem has been facing multiple challenges, including illegal logging, pests and diseases, cattle grazing, forest fires, and generally unsustainable management practices. Forest is the predominant ecosystem in Georgia, covering up to 40 percent of the country, and also the ecosystem that supports the richest biodiversity, with unique endemic tree species and some of the oldest pristine forests in the European region. Forests cover diverse landscapes and perform diverse functions, including: biodiversity conservation; water balance maintenance; retention of soil fertility; prevention of erosion, flashfloods, landslides and avalanches; carbon sinking and storage; and ecosystem, cultural and health services. However, high demand for firewood from rural communities is leading to deforestation and forest degradation.

This poses a serious risk to the booming tourism sector. Tourism is one of the fastest growing services exports from Georgia and an increasingly important economic sector. Protecting the delicate ecosystem in Georgia will be critical in supporting further development of the tourism sector. Encouraging sustainable practices in tourism development will also be important.

Legacy pollution from hazardous mining waste is a major issue. This is particularly relevant in Ambrolauri municipality, where about 100,000

tons of arsenic waste have been identified. In 2013, flooding of the Tskhenistskali River caused the release of the arsenic waste, creating an emergency. Manganese mines abandoned without proper conservation threaten human and environmental health in Chiatura municipality. Unspecified amounts of obsolete pesticides scattered in agricultural areas, as well as some 2,800 tons of those temporarily stored at Ialguja site without proper packing, represent other sources of soil and water pollution from hazardous substances.

Georgia is exposed to a wide variety of natural hazards, notably floods, debris and mudflows. These have contributed to most of the natural disaster-related fatalities and economic losses. The 2000 drought in the regions of Kakheti and Kvemo-Kartli affected 696,000 people and caused economic losses of US\$200 million. The 2012 storms that damaged agricultural land, homes, and municipal infrastructure in eastern and southern parts of the country caused losses of US\$123 million. Large landslides and related flooding of the Tergi River in 2014 destroyed infrastructure and interrupted international road transportation between Georgia and the Russian Federation. More recently, the 2015 flood event in Tbilisi caused estimated economic damage of US\$50 million. The occurrence of natural disasters appears to be on an increasing trend due to local deforestation and the global climate change.

Risks posed by climate change could adversely impact various sectors of the economy, including agriculture and hydropower generation. While the impact of climate change on the overall intensity and frequency of hydrological hazards cannot be predicted with certainty, data suggest that extreme wet and dry episodes have increased in recent years in both frequency and amplitude. This is likely to affect river runoff and lead to the more frequent occurrence of floods and landslides. The risks to the agricultural sector are immediate and important because the rural poor depend disproportionately on agriculture for their livelihoods and have limited adaptation capacity. Georgia has the third-largest hydropower potential in Europe with only about one-fifth of the economically feasible potential developed. The country has a hydropower-dominated power system with the hydropower station, Enguri, generating 70 percent of the total demand, while small and medium hydropower plants and gas-fired thermal power plants produce the rest. Adverse climatic changes thus threaten the energy security of Georgia. In this context, heavy reliance on hydropower generation

is not sustainable for the country. The energy sector strategy needs to embrace diversification of the energy generation mix to include other renewable energy sources.

Hydropower development could itself have negative impacts on the environment. Excessive dependence on hydropower is associated with possible hydrological risks and population displacement, and risks for cultural heritage sites. The transformation of landscapes through hydropower development projects could affect the delivery of important ecological services and undermine nature-based tourism prospects. In short, there is a need for a more systematic assessment of environmental and social impacts. There is no coordinated management of water resources in Georgia. Water is used by the hydropower sector, agriculture, tourism, and transport. There is no clarity on how to prioritize usage, allocate water, and resolve disputes. It is unclear how much water hydropower plants will be allowed to use in the future. With no single requirement for water-use permits, there is a legal and contractual gap in the case of a conflict over the usage of water. Finally, there is no fee for water usage, which is an unusual practice worldwide.

Notes

1. OECD/IEA (2016).
2. UNECE (2016).
3. UNECE (2016).

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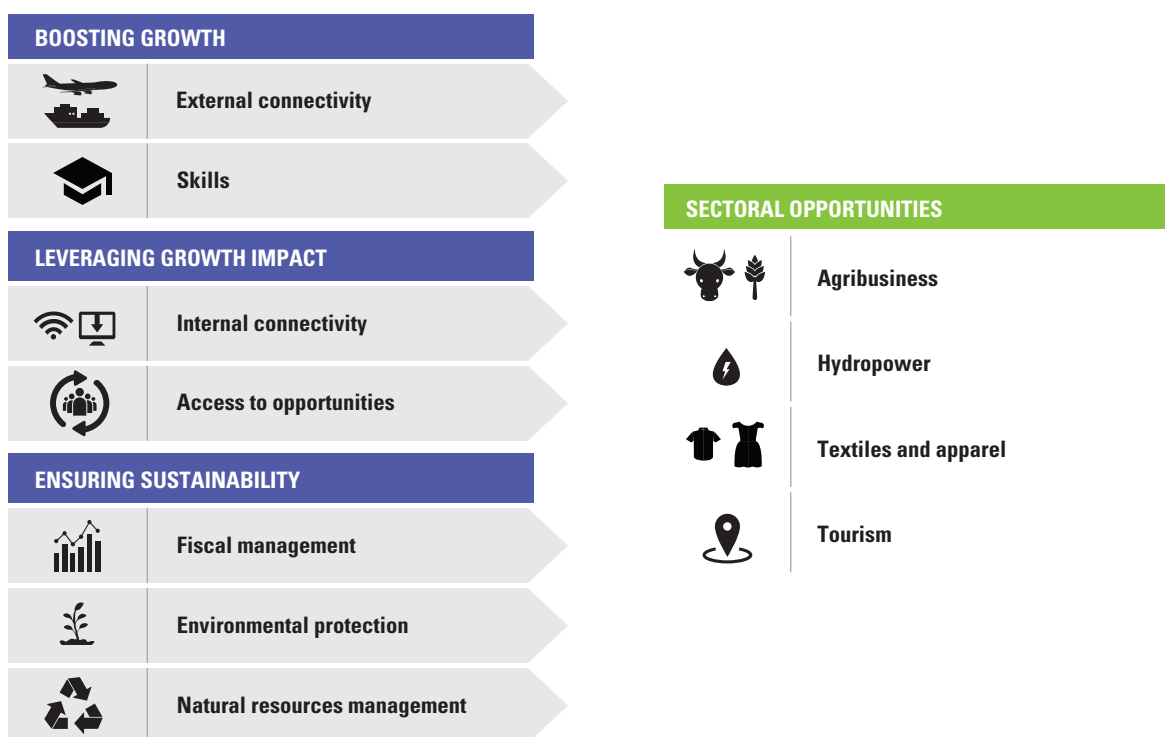
CHAPTER 6

PRIORITIZATION

Based on the evidence and analysis presented in this report, this chapter summarizes the main constraints that Georgia faces in **amplifying progress toward the twin goals**. The principal conclusion is that further progress will hinge critically on Georgia's ability to maintain high rates of economic expansion, through recalibrating its growth model to allow the country to continue to move up along the development value chain. Extending the growth performance of the past decade will require a determined focus on enhancing the competitiveness and export-orientation of the economy, and productivity in key sectors of the economy.

Georgia will only be able to maintain high growth if it **boosts connectivity and upgrades the skills of the workforce**. Key conditions for progress to be sustained over time includes addressing threats to fiscal stability and preserving the environmental through active natural resources management. Greater focus will be also be required—although this remains an area of relative knowledge gaps—on ensuring that the pro-poor potential of growth is maximized, by addressing the underlying causes of economic dualism, which currently inhibits an optimal use and deployment of the country's human capital (figure 6.1).

FIGURE 6.1
Priorities for Inclusive Growth



Source: Georgia SCD team.

These priorities were identified by applying three sets of filters, namely twin goals relevance filters, stakeholder consultations for economy-wide constraints, and sector-level micro-assessments for the sectoral focus areas.

- **Twin goals filters:** These included benchmarking actions and priorities against expected impacts on growth, inclusion, and sustainability. A stylized representation of this exercise is shown in table 6.1.
- **Stakeholder consultations:** A first round of consultations took place in December 2016, which helped to identify the broad range of areas to be covered in this Systematic Country Diagnostic. During a second set of consultations in May 2017, the team tested and calibrated the main hypotheses, through meetings with representatives from the public sector, as well as firms, academia, and civic society.
- **Micro-assessments:** To identify the most promising sectors (zooming in on those sectors with the greatest potential and strong comparative advantage), the team deployed sector scans, which the International Finance Corporation developed for the new Country Private Sector Diagnostics (see appendix D for results and details).

Combining the insights from the filtering process, key priorities can be identified along the hierarchy of top and high priorities.

- Top priorities, including those actions that can unlock productivity improvements and thus help Georgia to maintain high rates of economic growth going forward.
- High priorities, include those policies that: (i) would alleviate economic dualism so that Georgia's human capital can be better developed and deployed; and (ii) are required to ensure that the growth and inclusion model remains sustainable over the medium to longer run.

Priority #1: Integration into global value chains.

Rationale: The domestic market is too small to support high rates of growth, while Georgian firms also lack access to managerial and technical skills and the necessary know-how to boost productivity. Integration in global value chains (GVCs) would help to address both constraints. The surest way to overcome information bottlenecks and discovery costs for Georgian firms seeking to access external markets is through GVC integration. Moreover, the FDI that comes with such integration can help

TABLE 6.1

Twin Goals Filters

List of constraints	Scores		
	Relevance to growth	Relevance to inclusion	Relevance to sustainability
Solid foundations			
• Macro and fiscal risks	✓	✓	✓
• Low efficiency of institutions	✓		
Productive individuals			
• Low educational achievement	✓	✓	✓
• Lack of skills	✓	✓	
• Economic dualism and lack of convergence	✓	✓	✓
Dynamic and competitive firms			
• Limited participation in global and regional value chains	✓		✓
• External and internal connectivity	✓	✓	✓
Public assets and resources			
• Increasing energy security	✓		✓
• Safeguarding environmental sustainability		✓	✓

Source: Georgia SCD team.

address managerial deficiencies that currently limit productivity growth in domestic production.

Strategies: Combine a smart direct investment promotion strategy into high potential sectors with export intelligence interventions to reduce firms' discovery costs. Both anecdotal and systematic quantitative analyses in Georgia indicate high discovery costs to introduce new products and reach new markets. Export and investment promotion could be powerful tools to support firms' internationalization through GVCs.

Priority #2: Tackling hard and soft connectivity constraints.

Rationale: With a strategic location that has been made even more attractive by recent trade agreements, Georgia can benefit from easy access to the European Union and regional markets if it tackles connectivity constraints.

Strategies: In today's globalized economy, logistics are as important as hard infrastructure and Georgia has a significant deficit in this space. Specifically, upgrading the port of Poti, which is often congested, by improving its restricted draft and increasing storage capacity, would help to strengthen the development of a container supply chain along the Caucasus Transit Corridor.

Priority #3: Upgrading skills for the new economy.

Rationale: If Georgia's economy can create more and better jobs, its workers will need to be ready to avail themselves of the new opportunities. But although the country has effectively addressed constraints in access to education and training, the quality of these services remains very poor. Shortcomings are particularly important in the soft skills (ability to learn, leadership, autonomy, languages) that are in highest demand in the new economy. Skills shortages are also apparent in specific sectors (textiles and apparel, hospitality, and agriculture), where they hamper prospects for moving up the value chain.

Strategies: A broad-based strategy of quality upgrading in the educational system will need to be complemented by targeted efforts to supply Georgia's leading sectors (tourism, textiles, energy) with the occupation-specific skills that are currently missing. In specific areas, this may even require

well-crafted programs to promote immigration to Georgia (whether of foreign nationals or of the Georgian diaspora).

Priority #4: Equalizing access to opportunities and investing in people.

Rationale: Today the country is fractured between islands of prosperity and opportunity (mostly in a few cities) and a vast rural hinterland characterized by limited mobility and very low productivity.

Strategies: Equalizing access to opportunities through spatially targeted approaches to reduce gaps in access to quality education and health would go a long way toward ensuring that those in urban and rural areas have the same potential to contribute economically. These policies would need to be complemented by actions that directly target the sources of immobility among the rural population, which are not well-understood at this time. It is important to create opportunities for women—especially rural women in unpaid jobs—to join the workforce, as they are particularly vulnerable to being left out of the labor market.

Priority #5 Modernizing agriculture and leveraging tourism potential.

Rationale: A key driver of economic dualism is the limited dynamism of the rural economy, which remains highly labor-intensive but also highly unproductive. Thus, modernizing agriculture and leveraging tourism potential would have the benefits of: (i) improving livelihoods for those who choose to remain in rural areas; (ii) freeing up excess labor that can be more effectively deployed in Georgia's dynamic cities; and (iii) enhancing Georgia's export competitiveness.

Strategies: To make agriculture more productive and increase its potential for commercialization, Georgia will need to develop effective land markets, adopt a value-chain approach to production to ensure that complementary inputs are available for commercialization, and upgrade the capacity of producers to meet export standards. To expand Georgia's potential in tourism, the main priorities include: (i) removing connectivity bottlenecks (internal and external); (ii) bridging specific skills gaps in hospitality; and (iii) developing quality standards for the industry.

Priority #6: Maintaining a sustainable fiscal and financial position.

Rationale: Sound macroeconomic stance matters for growth and inclusion alike. Macroeconomic stability is key for investment—particularly FDI for which perceptions of country risk are critical. From this standpoint Georgia has a solid track record of prudent fiscal and financial sector management and flexible exchange rate policies, which will be important to maintain. On the fiscal front, the recent crises and the introduction of universal health care have both put pressure on the budget and raised the bar for policymaking. Ensuring that adequate fiscal space is maintained will be critical for the state to be able to build its infrastructure stock and deliver essential social services.

Strategies: To continue to build the country's stock of human and physical capital, policymakers will need to: (i) develop a medium-term fiscal policy framework that balances the objective of supporting the economy, while maintaining a sustainable macroeconomic stance and rebuilding a cushion to respond to future shocks; (ii) make public expenditure more efficient so as to maximize the impact

of each dollar spent, specifically with regard to the management of the UHC program; and (iii) monitor and address contingent liabilities that could stem from state-owned enterprises operations, PPPs and public power agreements.

Priority #7 Preserving the environment.

Rationale: Preserving Georgia's natural environment is a pro-poor and pro-growth imperative. Most of Georgia's poor live in rural areas and depend directly on the environment for their livelihoods. Moreover, the country's nature is also a key economic asset, with recognized potential in tourism and organic farming. **Strategies:** To ensure that economic development goes hand in hand with environmental protection, the focus should be on sustainable natural resources management. This would include: (i) investing in environment quality monitoring; (ii) developing frameworks for the sustainable use of forest and mining resources; and (iii) promoting integrated water-basin planning in the context of hydro-power development.

BOX 6.1

Knowledge Gaps

While this Systematic Country Diagnostic has contributed to a better understanding of the drivers of economic growth, poverty, and inequality dynamics in Georgia, there remain several knowledge gaps that would benefit from further investigation.

- The underlying causes of “economic dualism,” which currently inhibits an optimal use and deployment of the country's human capital; constraints on mobility and urban-rural territorial inequalities and their implications for policy, particularly in the context of a shrinking population.

- The existing incentives and obstacles to registering informal firms, which could explain high levels of firm informality and self-employment in Georgia.
- Detailed firm-level productivity analysis, which could potentially be based on the national enterprise, business environment, and investment climate surveys, trade data, and other firm-level surveys.
- Constraints to competition in Georgia and weaknesses in the judicial system.

Quality of health care and the unit cost of health care services provision.

Source: Georgia SCD team.

APPENDIXES

POVERTY MEASUREMENTS

In recent years, several poverty lines have been used to measure poverty in Georgia. Though international best practice is to use an absolute poverty line to measure poverty rates within the country, Georgia has been monitoring poverty using a relative poverty lines. With the adoption of the Sustainable Development Goals, the country has gradually begun reporting and monitoring poverty based on an absolute poverty line. This new poverty line is estimated using the Cost of Basic Needs method, which calculates the money needed for covering a minimum basket of goods for decent living. This amount was

estimated at GEL 130 per month for an adult in 2015. Before the introduction of this absolute poverty line, the poverty rate in Georgia has been calculated at US\$2.5 per day per average person (2005 purchasing power parity). The poverty trend for the country is broadly very similar irrespective of the poverty line used. In the analysis to be presented in this report, the national poverty line will be used for all Georgia-specific analysis with an international line being used whenever it becomes necessary to compare the country with other countries in the world.

GEORGIA – A SHORT POLITICAL HISTORY

Soviet Union as an independent state in 1991, Georgia became the arena of conflicting interests. Tense relations with the Russian Federation have been further exacerbated by Moscow's support for the separatist regions of Abkhazia and South Ossetia. These tensions between Moscow and Tbilisi flared up into an armed conflict in August 2008, which resulted in hundreds of casualties and thousands of refugees.

Georgia aspires to become part of the European Union (EU) family, has ambitions to join North Atlantic Treaty Organization (NATO), and its troops serve in Afghanistan as part of International Security Assistance Force operation. The US has a major strategic interest in the country, having invested heavily in an oil pipeline from Azerbaijan via Georgia to Turkey. There is an increased US economic and political influence in the country, along with Georgia's aspirations to join NATO and the EU.

Post-Soviet Years

Following the collapse of the Soviet Union in 1991, Georgians overwhelmingly voted for the restoration of independence and elected nationalist leader Zviad Gamsakhurdia as president. However, he was soon overthrown by opposition militias, which in 1992 installed former Soviet Foreign Minister Eduard Shevardnadze as the country's new leader. His 11 years in office were controversial as the government was not able to control crime and corruption. President Shevardnadze was ousted in November

2003 following mass demonstrations, widely known as the Rose Revolution.

The **Rose Revolution** was a pro-Western peaceful change of power in Georgia in November 2003. The revolution was brought about by widespread protests over the disputed parliamentary elections and culminated in the ouster of President Shevardnadze, which marked the end of the Soviet era of leadership in the country. The Rose Revolution triggered new presidential and parliamentary elections, which established the United National Movement (UNM) as the dominant ruling party. Following the Rose Revolution, Georgia pursued a distinctly pro-Western foreign policy and declared European and Euro-Atlantic integration as its main priority. This change in direction contributed to Georgia's tensions with the Russian Federation, which continue to this day.

Following the explicit declaration of its pro-Western aspirations, Georgia lost the cheap energy to which it had access during the Soviet period. As relations between Georgia and the Russian Federation deteriorated, Moscow tightened the economic screws, subsequently ripping out trading ties and introducing sanctions, which caused Georgia's economy to nose-dive. Georgia has been heavily dependent on the Russian Federation for its energy supply. Similar to some other states of the former Soviet Union, it saw the price of gas supplied by the Russian gas giant Gazprom rise sharply in January 2006. Gazprom has since doubled the price again. The most recent development, however, is that in January 2017 Georgia

signed an agreement with Gazprom, according to which it will shift to a system of financial compensation with this energy giant for the transit of Russian gas through Georgia into Armenia. The government decided to sign a new two-year agreement with Gazprom as the former agreement expired on December 31, 2016. The new agreement entails monetary compensation for the transport of Russian gas to Armenia through Georgia in place of the former arrangement, which afforded Georgia 10 percent of all natural gas transported through the country.

Since independence, the people of Georgia have endured periods of civil war and unrest, as well as violence related to the independence aspirations of the breakaway regions of Abkhazia and South Ossetia. Both regions had close ties with Moscow, and following the August 2008 events in South Ossetia and the subsequent five-day armed conflict with the Russian Federation, the latter announced it was formally recognizing the independence of Georgia's breakaway regions. Despite the ceasefire negotiated under the heavy international pressure and diplomatic intervention from a number of international leaders, Russian troops still remain entrenched in the sovereign territory of Georgia. Their continued movement of borders closer to the strategic East-West Highway and the Georgia-Azerbaijan pipeline is widely referred to as "the creeping occupation".

The consequences of the international conflict, the global financial crisis of 2008, and the growing number of human rights violations in the country, created a fertile ground for a popular discontent with the UNM. Consequently, the opposition was formed to challenge the incumbent party in the 2012 elections.

The **Georgian Dream – Democratic Georgia** was the party which consolidated the opposition momentum in Georgia. Established on April 19, 2012, by the businessman Bidzina Ivanishvili, the party evolved from the public movement Georgian Dream, launched by him as a platform for his political activities in December 2011. The party successfully challenged the ruling UMN in the 2012 parliamentary election. It won this election in coalition with six other opposition parties, with 54.97

percent of the vote, winning 85 seats in parliament. The governing UMN took 40.34 percent. President Mikheil Saakashvili conceded that his party had lost and pledged to support the constitutional process of forming a new government.

In June 2014, Georgia signed an Association Agreement with the EU. The Agreement, which includes a Deep and Comprehensive Free Trade Area, marks several years of cooperation between Tbilisi and Brussels under the Eastern Partnership program, and represents the first step on Georgia's journey toward membership. It describes the gradual improvements needed in areas such as trade, environment, agriculture, tourism, energy, transport and education to bring Georgia into line with EU standards. Overall, the process is focused on democracy and the rule of law, human rights, good governance, and economic development.

On February 2, 2017, the European Parliament voted in favor of visa-free travel for Georgian citizens to the Schengen Area at a plenary session. Starting in spring, Georgian citizens will be able to travel visa-free to most countries of the European Union. Holders of Georgian biometric passports will now be able to enter the Schengen Area for 90 days within any 180-day period for holiday, business and other purposes except for that of working. European Parliament and Council negotiators struck a deal on visa-free legislation last December. The visa waiver for Georgia will enter into force simultaneously with the visa-suspension mechanism, on which EU institutions have already reached an agreement.

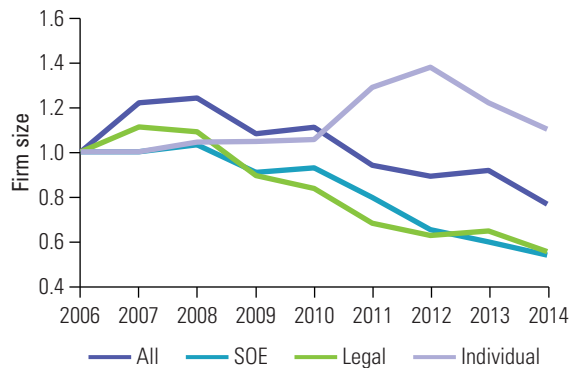
The Georgian Dream party is in its second term, having won 2016 parliamentary elections in October 2016. However, despite a convincing showing of 48.65 percent of the votes, a number of independently conducted polls show the public's confidence in the party's abilities and goodwill waning. The current dissatisfaction can be attributed to a number of factors, with unemployment being major among them. The recent nosedive of national currency value (from GEL 1.7 to US\$1.00, down to GEL 2.7 to US\$1.00) against the U.S. dollar has exacerbated these concerns.

FIRM DYNAMICS

FIGURE C.1

Average Firm Size Has Been Falling over the Years...

Relative to size in 2006, by type of firm



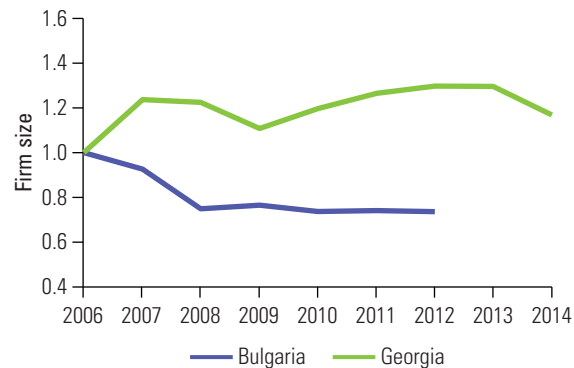
Source: Jobs Diagnostic, World Bank Group.

Note: State-owned enterprises comprises sole state owners and mixed ownership.

FIGURE C.2

...Although Less Intensely in Manufacturing

Bulgaria and Georgia, manufacturing



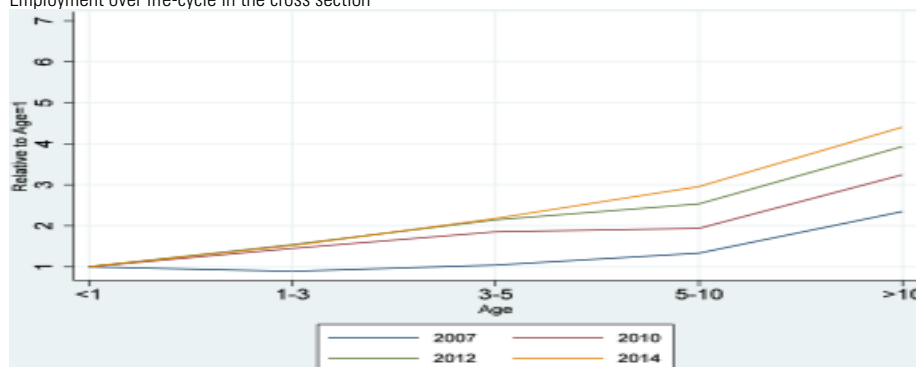
Source: Jobs Diagnostic, World Bank Group.

Note: State-owned enterprises comprises sole state owners and mixed ownership.

FIGURE C.3

Increasingly, Firms Display More Dynamism over Their Life-Cycle

Employment over life-cycle in the cross section



Source: Jobs Diagnostic, based on Business Survey from GeoStat.

SECTORAL MINI-DEEP DIVES

Four sectors display high potential as drivers of export-led growth, namely commercial agriculture, energy, textiles and garments, and tourism. The first two are sectors in which Georgia has a latent comparative advantage, with significant endowments that could be better exploited. The latter two are sectors in which Georgian firms are gradually seizing the opportunity that integration into global markets provides, but where there is substantial scope for growth. The following sections describe their performance over the years and the prospects, together with the obstacles, that are holding back their growth potential.

Commercializing Agriculture

The performance of the agricultural sector has been disappointing over the past two decades. Agriculture remained a mostly unproductive subsistence activity. Georgia is a traditional agrarian country with about 40 percent of its territory consisting of agricultural lands and 46 percent of the population living in rural settlements. However, the performance of Georgian agriculture has been poor compared with that of other transition economies. The share of agriculture in gross domestic product (GDP) fell from around 50 percent in 1994 to less than 10 percent in 2016, a much steeper decline than seen in other Commonwealth of Independent States (CIS) countries. Despite its insignificant contribution to the economy, the sector employs about 52

percent of the workforce. About 83 percent of those employed in agriculture are self-employed,¹ pointing to the main function of agriculture being to provide a safety net for hundreds of thousands of underemployed individuals living in rural areas. Small farms dominate the sector, accounting for 96 percent of the arable crop area and over 96 percent of cattle and sheep as of 2015. Unorganized, operating on small plots of land,² and lacking in skills, infrastructure, and essential support services, many of Georgia's smallholders remain in agriculture due to old age, emotional attachment to their land, and a lack of other opportunities.

Agriculture has unexploited potential. The agro-food industry is a major employer in developed economies and this sector has strong commercial potential in Georgia, thanks to fertile land, favorable agro-climatic conditions, ample water resources, and unique traditions (for example, in winemaking, honey, and so on). Growth opportunities stem from the rapid expansion of high-value fruit and vegetable consumption in traditional CIS markets, improved access to the European Union (EU) and Chinese markets as a result of trade agreements, and growing domestic demand. Gradual commercialization of the sector can be a great avenue for lifting rural population out of poverty.

Two fundamental challenges include deficient agricultural “hardware” and outdated “software.” The first includes excessive land fragmentation, aged plantations, infrastructure bottlenecks, and a lack of

capital. Dealing with hardware issues would require time and well-coordinated public and private investment. The “software” challenge relates to skills and knowledge deficits among Georgia’s rural population, low motivation to learn, a culture of informal business dealings between friends and relatives, as well as weak capacity of the public sector to deliver modern services. This is incompatible with modern international standards and organizational practices, and a major barrier for inclusion in modern value chains (export, retail, and processing).

Organization of the Sector: Vertical and Horizontal Fragmentation

Land fragmentation is one of the major barriers for the further development of agriculture. Currently, after three phases of agricultural land privatization,³ only 15–20 percent of land titles are registered. The parcels allocated to the households, averaging 1–1.2 hectares in size, often lack access to basic infrastructure. Many of them are unsuitable for individual farming activities and are used for pasture, or not cultivated at all. Actual land use now deviates from the original land title documents for a variety of reasons, such as inheritance, intra-family transfers, informally recorded sales, and encroachment into adjacent state land not supported by documentary records. This causes disputes during land transactions, creating a disincentive to lease, sell, or invest in land and undermining the value of land as collateral. Land fragmentation also explains the prevalence of small-scale farming.

Still, the main problem remains a lack of skills. Fragmentation is an obstacle for scale-sensitive agriculture, which relies on sophisticated machinery (for example, grain and oilseed), or production and marketing processes (mass winemaking). However, an increasing number of agricultural activities are not scale-biased. Technological innovations that significantly boost agricultural productivity can be introduced by small-scale farmers.⁴ This includes simple changes in cultivation and orchard management techniques, skilled use of fertilizer and pesticides, reduced postharvest losses thanks to better storage, packaging, and transportation and stronger links with other value chain actors. This is fully applicable to the kind of labor-intensive niche agriculture where Georgia has the capacity to be competitive (kvevri wine, hazelnuts, and, potentially, kiwifruit) and in high value-added niche products that are difficult,

or expensive to produce (for example, kosher, halal, biodynamic, or organic fruit). However, few of the Georgian small farms have the appetite or capacity to introduce such changes.

Low productivity and dismal business practices limit the integration of smallholder farmers into modern value chains and growth of processing companies. Smallholder farmers are not capable of delivering the supply of raw materials of satisfactory and consistent quality and sufficient quantity. They also tend to renege on long-term supply contracts if presented with short-term opportunities. Another supply-related issue, which is likely to become more of a problem as EU-style sanitary and phytosanitary standards are enforced, is the lack of documentation throughout the production cycle. The fragmented and uneven nature of the supply chain ultimately limits the ability of processors to fully utilize installed capacities and increase scale. Problems with the supply chain can drive modern, export-oriented food processing enterprises out of business and out of Georgia.⁵

Farmer cooperation has not yet demonstrated consistent results in terms of improving agricultural productivity and linking farmers to markets. Cooperation among smallholders on service provision, product consolidation, processing, branding, and marketing appears to be a promising way to place Georgian niche products on international markets, while preserving the country’s unique way of life and social fabric. However, most Georgians continue to associate farmer cooperation with Soviet Union-style joint ownership of land and joint agricultural production, as opposed to joint processing, branding, and marketing. This misconception was a key reason for the failure of efforts to ignite a genuine farmer cooperation movement (box D.1).

Excessive fragmentation in the downstream segment of agricultural value chains is another obstacle for consolidation of Georgia’s agricultural exports. For example, the export of mandarins in Adjara is handled by several dozens of small, poorly equipped and managed sorting and packaging centers. These centers compete for raw materials among themselves and with four larger processing plants. However, each one is too small to afford the kind of specialized sorting, calibration and packaging equipment that would allow placing Georgian mandarins in the premium segment—modern retail networks. Most commonly installed sorting and calibration lines are not tailored for mandarins,

BOX D.1

Fostering Farmer's Cooperation in Georgia: Lessons Learned

Most cooperatives were registered to be eligible for concessional funding. While this support allowed beneficiary enterprises to upgrade their production or processing facilities, it did little to further genuine farmer cooperation. Therefore, for development-partner and government assistance to be better targeted, the criteria for farmer cooperatives should be tightened. Features that can help distinguish genuine farmer cooperatives include: (i) participation of a relatively large number of farmers with a relatively equal distribution of control; (ii) the main goal of cooperation is product aggregation, storage and processing, not production per se; and (iii) presence of strong leadership, provided by a trusted external broker such as government, a local religious leader, or business seeking to develop its supply chain.

International nongovernmental organizations (NGOs) are not necessarily the best enablers of cooperation. While able to apply for and manage development-partner funds, such NGOs often lack the relevant agronomical, food processing, industrial management or marketing expertise. They do not have a

genuine stake in the development of Georgian agriculture. Driven by the 3-to-4-year funding cycles of most development-partner organizations, their business model is not compatible with the long-term task of fostering sustainable farmer groups. Private sector players, particularly buyers of agricultural products, are better positioned to provide the necessary leadership and expertise, given that they have a long-term interest in developing the capacity of farmer groups.

There is a role for government and development-partner organizations in catalyzing business engagement with farmer groups. For example, governments could incentivize private players through land concessions conditional on engagement with smallholders and smallholder groups. The World Bank experience in building “productive alliances” involving smallholder farmers and downstream actors in Latin America may provide useful insights.

Source: Livny and Maximov 2017.

physically damaging the fruit; mandarins are typically packaged in low quality plastic, which results in additional damage and transportation losses. For now, practically all Georgian mandarins are sold in the lowest price segment of the market.

Going forward, policymakers will need to create the conditions for consolidating the sector and attracting private investment in agro-food industry. Private sector investment is unlikely to be forthcoming until there is a critical mass of farmers producing the consistent quality needed by buyers. While efforts to promote further farmers' cooperation should be continued, a broader set of measures is needed to help address the fragmentation of the sector, including:

- **Land market development.** While small farming can be efficient, formalizing/legitimizing land property rights will be fundamental for attracting greater investment in agriculture.
- **Value-chain infrastructure, including storage and sorting facilities.** While public-private partnerships in value-chain market infrastructure are currently not commercially viable, they could become feasible once irrigation and other supporting services are in place.
- **Public-private dialog (PPD) to inform strategy and actions for agriculture development and promote greater producer-buyer coordination.**

PPD would help better understand and address private sector constraints to development. In the medium-term, these could evolve into industry associations to support export promotion, standard setting and industry compliance.

- **Compliance with food safety and quality standards.** Georgia has invested heavily in building the capacity of the NFA, harmonizing food safety legislation with EU legislation in line with the DCFTA, and developing disease control strategies. However, ensuring compliance in an environment of high sector fragmentation will be a challenge. Industry associations can be instrumental in driving compliance with standards.
- **Easily accessible templates of legal, financial and commercial documentation for transactions along the agribusiness value chain.** Ideally, relevant templates should be developed and made freely available in three languages (Georgian, Russian, and English). This would reduce transaction costs, help track transactions at various parts of the value chain, and provide Georgian companies with the possibility to legally defend their interests.

Access to Finance

Concessional financial resources offered to agribusiness companies have not addressed access to

finance problems. Many IFIs implement financial and technical assistance programs targeting Georgia's agricultural sector. Georgian farmers and agribusinesses are also offered generous subsidies through government programs such as "Plant in Georgia" and "Produce in Georgia," which help offset investment costs. Yet, farmers continue to be strained as far their CAPEX and working capital needs are concerned, and report access to finance as a key bottleneck (figure D.1). There are three key aspects to this issue:

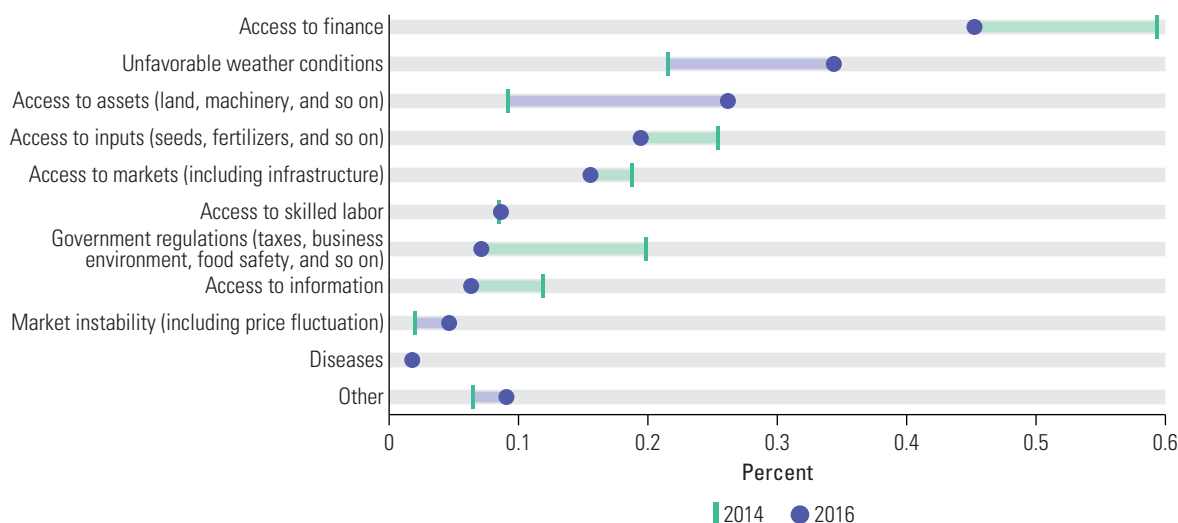
- *Georgia's agricultural sector is not ready for engagement with commercial banking.* Management capacity within Georgia's farming small and medium enterprises is very limited. There is little ability to generate project ideas and put them on paper in the form of a business plan for review by the banking sector.
- *While there is interest from financial intermediaries to enter the agricultural market, they lack sector knowledge and the ability to properly assess credit proposals.* Lacking capacity to correctly assess the value of agricultural assets, banks tend to pose relatively high collateral requirements. Use of commodity stock as collateral is very rare. Given the absence of reliable historical data, insurance products are priced at a level that most Georgian farmers cannot afford.
- *Georgia's agricultural sector is subject to very high commercial risks.* Producers of mass export commodities, such as hazelnuts, are subject to global

commodity price fluctuations. Farmers producing for the local market typically do not have long-term supply contracts and are often forced to sell into the glut. These commercial risks are exacerbated by poor protection against hail, cold, draught, and weather episodes, which can cause significant delays and spoilage of fresh produce exported via sea routes.

Addressing underlying failures of agro-credit market needs to be prioritized over the provision of subsidized credit. Promoting supplier finance could be a more feasible solution in the short to medium-term, while efforts to reduce risks in agriculture would pave the way for farmers' engagement with the commercial banks in the longer-term. Some of the large processors are already engaged with their suppliers in tolling schemes (providing cash, inputs and technical assistance with cultivation, postharvest treatment, packaging, and transportation in exchange for product supply). Further assistance in the formation of long-term links to the private sector (buyers of agricultural products) is desirable. A range of measures to reduce agricultural risks to commercially acceptable levels is still needed. Government guarantees could be used to reduce the risk of lending to exporters operating under long-term supply contracts. Investment in early warning and prevention systems (improvement of irrigation, anti-hail systems, spraying and vaccinations) could prevent or reduce weather-related risks.

FIGURE D.1

Growth Constraints for the Success of Small and Medium Farming Enterprises



Source: The annual survey of ENPARD-supported cooperatives, 2016.

Infrastructure, Logistics, and Supporting Services

Labor-intensive, high-value crop production such as for fruits and vegetables fundamentally depends on reliable and affordable irrigation services, which are currently lacking. Irrigation services which served close to 400,000 hectares during the Soviet era have been on constant decline since independence. The area served fell from 160,000 hectares in 2000 to 40,000 hectares in 2014.

While transport infrastructure is not reported as a major constraint for agribusinesses companies, related logistics services are significantly underdeveloped and major border crossings are problematic. Georgia is relatively well connected to the EU and Eurasian markets by road and ferries calling several ports on the Black Sea. Ports also provide the possibility of transshipment to destinations in North America, Europe and Asia. However, access to sea transportation is strained in the high season as Georgian exporters compete with Armenian freight forwarding companies, which results in very high prices. Access to the Eurasian market is also congested, particularly in winter months. Following the 2008 Russo-Georgian war, the Larsi border has become Georgia's (and Armenia's) main access point to this vast market creating major bottlenecks for exports into the traditional Russian Federation or CIS markets. Frequent delays on the Military Georgian Highway—caused by icy road conditions, avalanches or landslides—often paralyze Georgian exports. The situation with perishable, temperature-sensitive exports over Larsi is further exacerbated by the low quality of trailers involved in the operation.

The inability of smallholder farmers to access machinery is an additional constraint (figure D.1). In the 2000s, the government implemented a series of machinery programs that involved large international tenders for machinery, which was distributed on preferential terms of finance. This failed to provide the diversity of equipment needed or to establish functional service networks. In the second half of the 2000s the Millennium Challenge Corporation (MCC) helped establish 21 private machinery service centers. In parallel, MCC established 33 farm service centers offering a broader range of services and advice to farmers. In 2009, in the attempt to replicate MCC's success, the MOA established 13 state-owned machinery service centers. These competed poorly with privately-owned peers. The current government aims to privatize the state-owned service

centers, but their commercial viability remains questionable; a substantial quantity of machinery and equipment is either redundant or underutilized.⁶ The acute shortage of reliable farm machinery and operators, postharvest treatment contractors, cold stores and grain stores, and specialized food industry logistics is compelling foreign investors to spend considerably more on on-farm infrastructure and specialized machinery than would be the case in more developed jurisdictions.

Modern extension services remain underdeveloped. Globally, extension services enable small farmers to increase their productivity by helping them introduce new technics, access required inputs and machinery, establish links with potential buyer, and so on. Engaging local expert growers in extension services proved to be more effective than relying on service providers lacking practical experience. Many development partners provide various types of extension services in Georgia, but these initiatives remain fragmented. The MOA formally established about 60 Information and Consultation Service offices in 2013. While these offices hold numerous informational brochures, their staff is rarely qualified to answer professional questions, or deliver extension services.

Other supporting services, such as weather forecasting, soil testing and mapping, agronomical research and development, are also poorly organized. Meteorological services are provided by the Georgian National Environmental Agency, but they are relatively costly.⁷ Reportedly, Georgian farmers tend to rely more on reputable international weather forecasts. The procedure of soil tests conducted by the Scientific-Research Center of Agriculture and required to obtain funding under a state subsidy program, involves unnecessary bureaucracy. Large agribusinesses with foreign participation prefer to independently test soil samples overseas due to lack of trust in domestic services. More granular soil maps identifying the most optimal crops would be helpful for farmers to identify new crops to grow.

Developing Tourism

Georgia's tourism sector is a strong contributor to GDP, exports and employment. Between 2009 and 2016 Georgia, achieved one of the fastest rates of tourism growth globally. Total arrivals more than quadrupled over this time, reaching 6.3 million in 2016, of which about half were tourists.

Travel services became the largest and most dynamic export sector (figure D.2). In 2016, tourism directly accounted for an estimated 7 percent of GDP and employed 100,500 people (5 percent of total employment).⁸ Accounting for indirect impacts, this sector generated some 24 percent of GDP and supported around 350,000 jobs.⁹ Total export receipts from tourism increased from US\$475 million in 2009 to US\$2.1 billion in 2015 (figure D.3), which is three times higher than the total receipts generated by traditional agriproduce. At the same time, efforts to diversify the profile of foreign travelers have not yet born fruit. While progress was made in attracting additional visitors from Europe, Asia, the Middle East, North America, and Latin America, over 80 percent still arrive overland from Azerbaijan, Armenia, Turkey, and the Russian Federation.

Georgia needs to maximize its tourism sector potential. The underlying assets of the sector are sound and include history, cultural heritage, nature, wine and gastronomy, sea coast, and so on. Many natural and cultural assets are located in the rural areas and remain underutilized due to insufficient marketing efforts, poor connectivity, unsatisfactory customer services or accommodations, or limited industry specific knowledge on how to develop the promising segments of the sector considering emerging global megatrends in the industry. The latter includes the rise of technology mediated experience, growing demand for local authentic travel, the rise of millennial and third age travel. These trends will catalyze significant changes in demand and competition dynamics.

Accessibility

Air connectivity requires further strengthening.

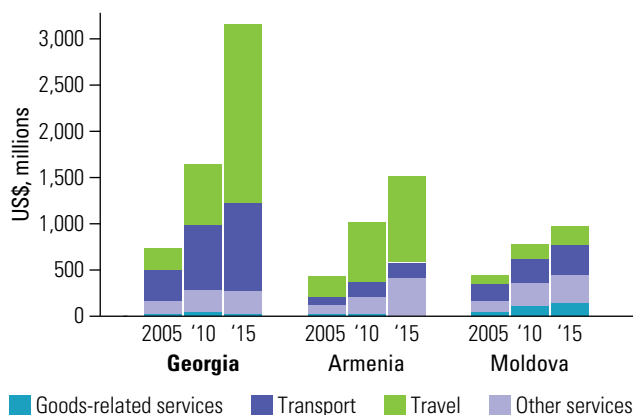
The aviation market has demonstrated considerable growth in the past few years. Total passenger traffic increased by 25 percent in 2016, making Georgia one of the fastest growing aviation markets in the world. All three international airports and one domestic airport comply with the International Civil Aviation Organization standards. Several airlines, including low cost carriers, have added capacity or launched services to Georgia in past few years; this trend is expected to continue. However, the number of tourist arrivals by air is relatively low. During 2016, only 1 million visitors (16 percent of total visitors) traveled to Georgia by air.¹⁰ The main constraints are the high level of airfare and airport taxes and insufficient capacity of the airports to accommodate growing interest of international carriers.

Road access and transport services are improving but still present limitations, especially to independent travelers. The government has given the highest priority to improving the East-West highway (Tbilisi, Adjara, Turkey) and the North-South corridor (Russian Federation, Georgia, Armenia). These roads are vitally important for transportation and tourism. Smaller rural roads vary in quality and maintenance, and many areas of the country are often cut off during the winter months. Bus networks are poorly developed, while many prime areas for nature and adventure-related development are only accessible in off-road vehicles. Road safety remains a serious issue.

FIGURE D.2

Services Exports

Georgia and comparators, 2005, 2010, and 2015

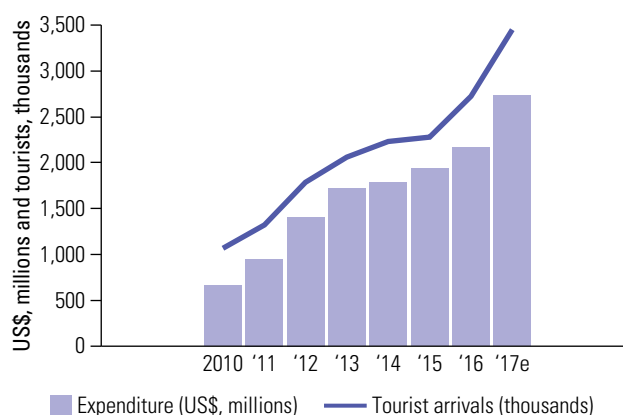


Source: World Bank Group staff calculations based on data from the United Nations Conference on Trade and Development.

FIGURE D.3

Georgia Tourist Arrivals and Expenditures

2010–17



Source: World Bank Group staff calculations based on data from the United Nations Conference on Trade and Development.

Poor management of circuits and itineraries, including trail maintenance and marking, as well as operating trails and interpretive services. Most of the popular sites are under the protection status managed by the Agency of Protected Areas of Georgia, but there is no national system of trail mapping, and therefore no national certification criteria for the trails system.

Hospitality Infrastructure and Services

Low quality of services and knowledge gaps impede emergence of high value-added activities. Hospitality services including tour operators, hotel personnel, transport services providers, are weak. In addition to industry specific skills, language and digital skills represent a major bottleneck for development in the new era of technology mediated travel experiences and rising customer services demands (see appendix B). To this end, expanding training opportunities for Georgians—particularly in rural areas where the greatest tourism potential lies is key. The education efforts should consider not only the needs of the relatively established product offerings, but also those of other promising market segments (for example, health and wellness, conferences, and exhibitions).

Large variation in standards and quality of products and services deter upper scale travelers from nontraditional destinations. Some regulatory control will be needed in the future, particularly in response to: (i) minimum standard expectations of larger international tour operators; (ii) demand of certain segments such as the third age travelers, and (iii) requirements for soft adventure markets (for example, skiing) where safety standards are important.

There is a gap in the market for affordable class quality hotels. Georgia attracted world class hotel brands, which are expanding their assets along with smaller domestic investors. It is estimated that Georgia's tourism accommodation capacity will expand by 40 percent over next two years.¹¹ Hotel properties affiliated with the international chains, offering reliable quality, account for about 10 percent of the market. They operate mostly in the 4–5 stars' segment, while affordable class hotel segment remains significantly underpenetrated; this deters certain traveler types from visiting Georgia. Outdated hospitality infrastructure is the primary challenge for the development of the Black Sea cost,

which requires smaller, more modern and more upscale resort facilities. Many heritage sites lack road access, nearby accommodations facilities and related infrastructure.

The preservation and sustainable commercialization of Georgia's environmental and cultural heritage are of critical importance. It is important that authorities, businesses, and residents of touristic areas recognize the value of natural and cultural assets, and that preservation plans are developed and enforced. This refers to a spectrum of issues that affect the quality of the product offering, including littering, waste management, pollution and biodiversity protection, heritage conservation, traffic congestion, social issues such as inclusion and internally-displaced persons, as well as the sensitive development or restoration of tangible and intangible cultural heritage. While there are several regulations in place, their enforcement remains challenging.

One of the most important needs for heritage sites is to adopt a standardized visitor management process. With an overwhelming number of historical monuments and a limited budget, some sites are neglected, and are not able to provide high quality interpretation or visitor services. It will be important to introduce "site management plans," train local professional staff and improve supporting infrastructure. This would help more fully realize their economic potential, while preserving sustainability.

Developing the tourism sector along the whole value chain should be prioritized. The increase of the foreign content in Georgia's exports is likely linked to the rapid development of the tourism sector, which heavily relies on foreign input. The opportunities to integrate domestic suppliers, particularly among agriproducers and family businesses providing hospitality services, should be explored more actively. Improving the skills set of family businesses and expanding quality and diversity of agriproduce will be critical.

Realizing Energy Sector Export Potential

Georgia's energy sector underwent a major transformation over the past two decades. In the early 2000s, in most areas outside Tbilisi, electricity supply was limited to less than six hours per day. Power theft and illegal connections were rampant. Technical and commercial losses amounted to over 50 percent. By 2007, the tariff reforms and greatly improved payment discipline allowed for uninterrupted power

supply across country. The sector has been unbundled into generation, transmission and distribution companies. The regulatory framework has become more predictable, straightforward, and investor-friendly. The tariffs allow reasonable cost recovery and return on assets, taxes are relatively low, licensing is simplified and power exports are allowed. These developments attracted significant investment in the sector and enabled the expansion of available power generation capacity. Georgia is also implementing extensive plans for reinforcing the transmission network. Furthermore, Georgia gained substantial benefits from gas transit from Azerbaijan to Turkey and from the Russian Federation to Armenia. Gas received at a below market price or as an in-kind payment for gas transit meets 41 percent of Georgia's total gas demand. This benefit is passed to residential consumers in the form of low gas tariffs and used for thermal generation.

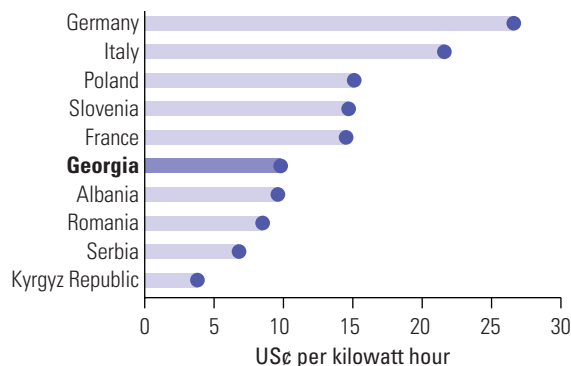
However, access, reliability, and affordability of electricity supply continue to be perceived as obstacles for business activities. In the latest available BEEPS (2013), almost 40 percent of medium firms ranked it as a major constraint. In the next five years, the implementation of the current government plan for hydropower development may require tariff increases by an estimated 85 percent by 2023.¹²

Limited power supply diversification undermines its reliability. The total installed power generation capacity of the country is about 3,600 megawatts, of which about 40 percent is firm (that

FIGURE D.4

Price of Electricity

Georgia and comparators, 2016



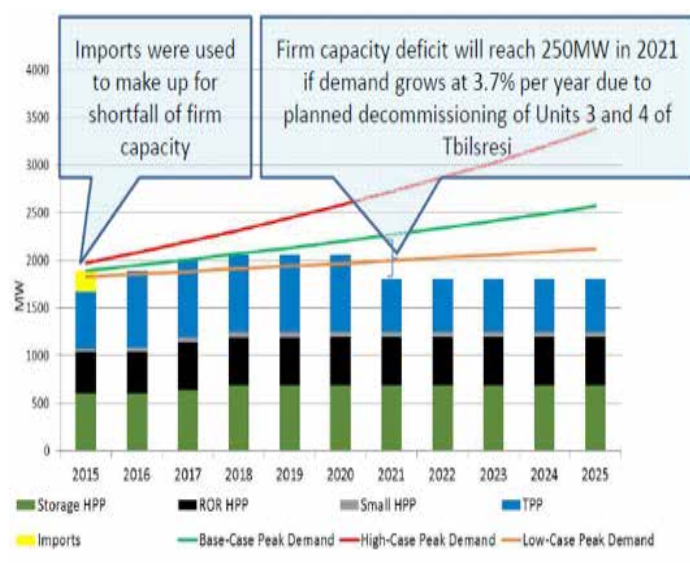
Source: World Bank 2016a.

is guaranteed to be available). Hydropower accounts for up to 90 percent of total electricity generation in wet years. During the summer, current capacity fully meets domestic power demand and allows for up to 600 gigawatt hours per year of exports to Turkey. During the winter, Georgia relies on more expensive thermal generation and imports, (1 terawatt hour per year of energy), mostly from the Russian Federation. The planned decommissioning of old thermal units by 2021, will further increase the deficit of firm capacity to meet winter peak demand (figure D.5). World Bank analysis shows that combined-cycle gas turbine power plants are the lowest cost option to fill this gap, which is also comparable to the cost of energy imports from the Russian Federation.¹³ Energy efficiency improvements and switching from electric heating to other heating options can play a role in reducing the winter supply-demand gap.

The reliability of the distribution system is emerging as an issue for the new power plants. Many distribution networks are in urgent need of strengthening. HPPs connected to the distribution grid reportedly have experienced frequent interruptions. Although technical and commercial losses have been significantly reduced in recent years, further improvements are desirable. The transmission and distribution tariffs are regulated according to the cost-plus principle, so distribution companies have limited incentives for reducing losses and improving efficiency.

Excessive dependence on hydropower for winter supply exposes the country to hydrological risks. A more systematic assessment of environmental and social impacts is needed, including of cumulative impacts from the development of multiple HPP in the same river basin. Water use rights will become

FIGURE D.5

Electricity Supply and Demand Projections, 2015–25

Source: World Bank 2016b.

a more serious issue when more HPPs come online (some with storage capacity). The right steps are being taken to create a coordinated approach to managing water resources, and to introduce a permit for water use rights.

Further reforms are needed to enable an internal electricity market. There is no short-term market; most electricity is contracted by long-term public power agreements between generators and ESCO. There is no balancing and ancillary services market. Balancing (covering day head planning and real time operation) is done by the Georgian State Electrosystem as Dispatch Licensee. ESCO calculates the balancing price monthly and settles the difference between actual and contracted energy.

The prospects of further development of Georgia's vast potential in renewable energy will depend on the performance of and access to the export markets. Georgia's hydropower potential is estimated at 50 terawatt hours, the third-largest in Europe, of which 20 percent is developed. The potential of wind and solar resources has not been well assessed and the framework for wind, solar and other renewable projects is not yet sufficiently developed. The further development of new generation capacity is held back by subdued demand in the main export market, insufficient transmission capacity and undeveloped domestic and regional power markets.

With vast hydro-potential and a favorable geographic location the country could become an energy hub. The country's gross hydropower potential is estimated at around 15 gigawatts, of which about 20 percent has been developed. If half of the remaining potential is developed for exports, it could generate some US\$1 billion of export receipts.¹⁴ Georgia also has a significant locational advantage to exchange power between energy producers, such as Azerbaijan and the Russian Federation with energy consumers like Turkey and Armenia. Furthermore, Turkey has a large interconnection with Europe, increasing power exchange potential in the future. Potential exports to Turkey are significant—up to 10.1 terawatt hours per year. In addition, Georgia is already becoming a natural gas hub, with gas transit from the Russian Federation to Armenia, Georgia to Turkey, and then on to Europe (Southern Gas Corridor). These volumes are scheduled to increase as additional gas is transited from Azerbaijan to Turkey, bringing additional benefits in a form of transit fees and below market prices for the domestic consumption.

Access to export markets will be vital to make the current and planned development of Georgian hydropower viable, given the natural limits to domestic demand. Turkey has been an attractive market for electricity exports. However, the market has recently slowed down considerably and the power price differential has been reduced and even reversed. While Turkey's long-term outlook looks promising, enabling power exports would require a more comprehensive regional power trading approach, whereby Georgia would establish itself as a regional trading hub.

To unlock the significant potential for regional power trade, Georgia needs to expand its cross-border transmission capacity, possibly with private sector participation to reduce fiscal pressures. Transmission and interconnection investments are already planned or underway. Georgia transmission plans include significant expansion of interconnections with Turkey and reinforcement of the interconnection links with the Russian Federation and Armenia. The completion of these projects would provide sufficient transfer capacity to enable beneficial cross border trade between Georgia and Turkey. The additional link with the Russian Federation is important to comply with system security constraints and stability. The link with Armenia (Back-to-Back) is considered as important for the Armenian system. The private sector can play a role in attracting the needed investment in the grid infrastructure and thereby reduce the fiscal pressures if the government creates an enabling framework and/or structures public-private partnerships.

Further development of the power sector regulatory framework and its alignment with the regional frameworks will be critical to enable regional power trade. The specific policy actions to improve the regulatory framework are spelled out above (see Section 3.1.1) and they are relevant for both domestic and export markets. Regulations which are particularly important for cross-border trade are those around grid connection. The cross-border capacity allocation rules are currently being clarified, but some concerns remain about the development of the Turkish grid and its ability to wheel power. The Georgian and Turkish system operators are applying explicit capacity auctions of the cross-border capacity at annual and monthly auction rounds. Each party is responsible for its import direction, and currently no netting of counter transactions is possible. There are users with priority rights and the rest of the capacity is auctioned. Current capacity is not fully exploited.

Going forward, potential HPP investors might fear that there will not be enough capacity in the export line if large HPPs come online. The total capacity of all HPPs projects with memorandum of understandings is at least twice the present capacity of the cross-border transmission line. Clear and transparent rules for allocating cross-border capacity are key for the investor confidence. To address this and other regulatory, institutional and market barriers to regional power trade, Georgia and Turkey will need policy decisions and a roadmap with coordinated measures.

Analyzing Textile Sector Potential

The analysis of performance in key global value chain (GVC)-prone sectors suggests that it is in textiles and apparel that firms have managed to integrate with international production networks. Textiles and apparel, electronics, and vehicles tend to be sectors in which trade is dominated by GVCs. Of these sectors, it is textiles and apparel, where Georgian firms have gained market shares. In 2015, of every US\$10,000 of world exports, US\$1.5 originated in Georgian firms, up from less than US\$5 in every US\$1,000,000 in 2000. The potential for growth in these and other sectors is exemplified by the market shares of Moldova that, due to the combination of a DCFTA with the EU and its proximity to key players in regional value chains (Germany, Romania), has managed to integrate more actively.¹⁵ Three products and one destination explain most of Georgian exports of apparel. The destination is Turkey, while the products are boy's trousers, cotton T-shirts and other T-shirts. In the first two products, Georgian firms have substantial scope for quality upgrading, as they currently are located at the bottom of the quality distribution (among competitors in the same segment), as proxied by the unit value they secure for these products.

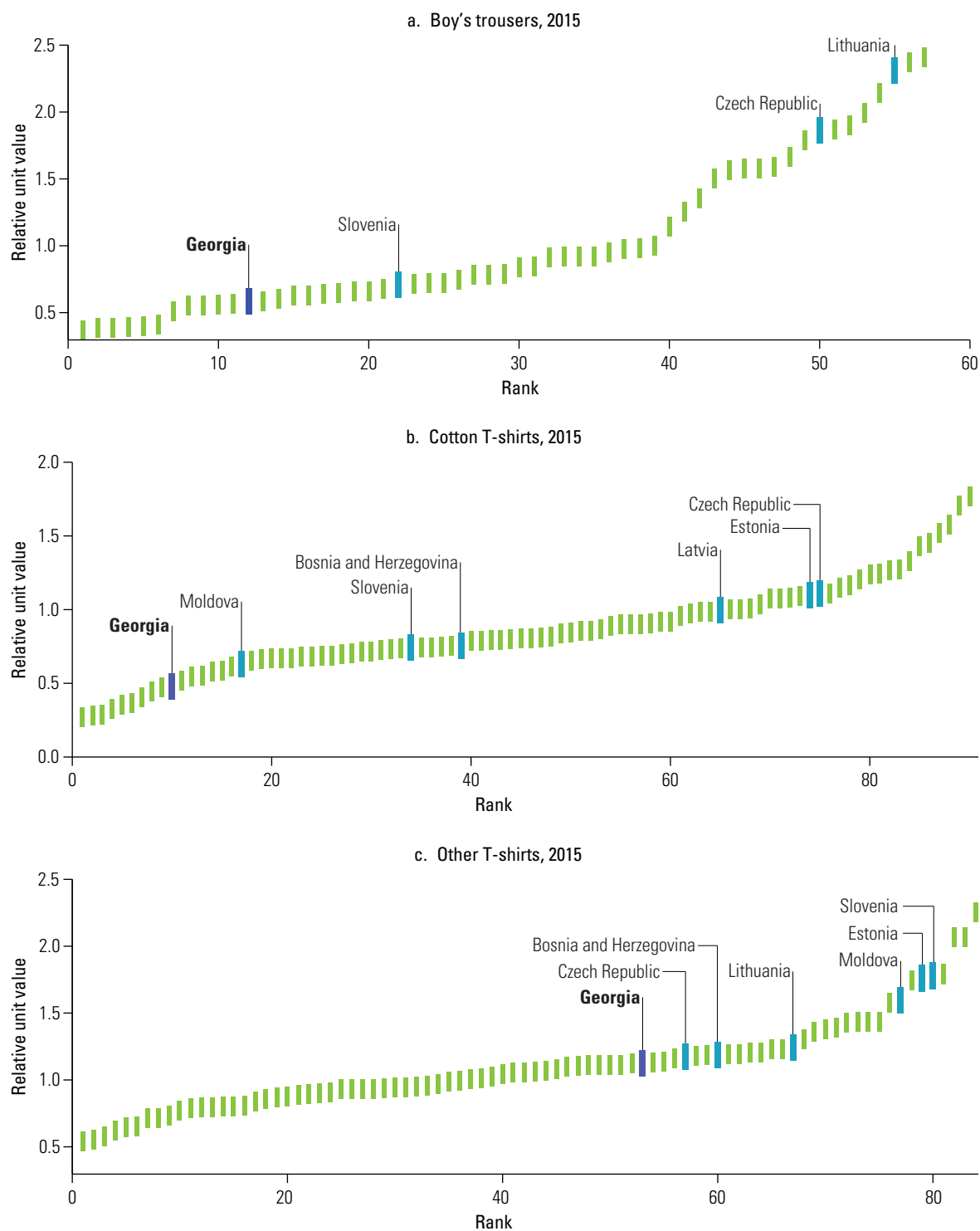
Georgia needs to build the skills of its workforce to move up into fashion design. The main obstacle that firms in the cut-make-trim segment of the apparel value chain identify relates to the lack of workers with expertise in, for example, sewing. As the sector grows, increased demand for skilled

workers will push wages up, compromising the main source of comparative advantage that firms currently have: low wages. Therefore, coordinated efforts are needed. On the one hand, the government may consider incentives to firms that do on-the-job training. This type of training may generate spillovers (since trained workers circulate across firms) and, therefore, public interventions may be warranted (currently, firms tend to train their workers at their own expense, likely leading to a sub-optimally low amount of training provided). On the other hand, vocational education interventions need to be strengthened, particularly those with focus on textiles and apparel and connected activities (for example, repairs of sewing machines). In addition to this, as automation advances, new skills related to digital drawing, printers' operations and template-making will be needed, and will facilitate the creation of more and better paid jobs.¹⁶

For Georgia to remain price-competitive to serve more than one destination policies focused on moving up the value chain need to take stock of crucial factors in existing success stories. While most of garment producers in Georgia focus on the cut-make-trim segment of this value chain (with little value-added as a share of the final output), some firms have moved up into original design, where value creation and wages are substantially higher, and so are wages paid. The organization of the semi-annual 'Tbilisi fashion week' has been a promotional platform for designers to venture into foreign markets and gradually grow. The firms that focus on original design tend to be small and leverage alternative business and distribution models. For example, they heavily rely on e-commerce platforms to get their produce to their foreign clients. In these area, three challenges have emerged: (i) the lack of a payments gateway in Georgia that allows foreigners to use their credit cards to directly pay the Georgian firm; (ii) the lack of clarity to handle clients returns from the point of view of Customs procedures (Customs considers the returned products as an import and charges import duties); and (iii) shipping costs that remain high and, for small volume shipments, compromise the feasibility of the distribution mode.

FIGURE D.6

Quality Ladders for Key Export Products

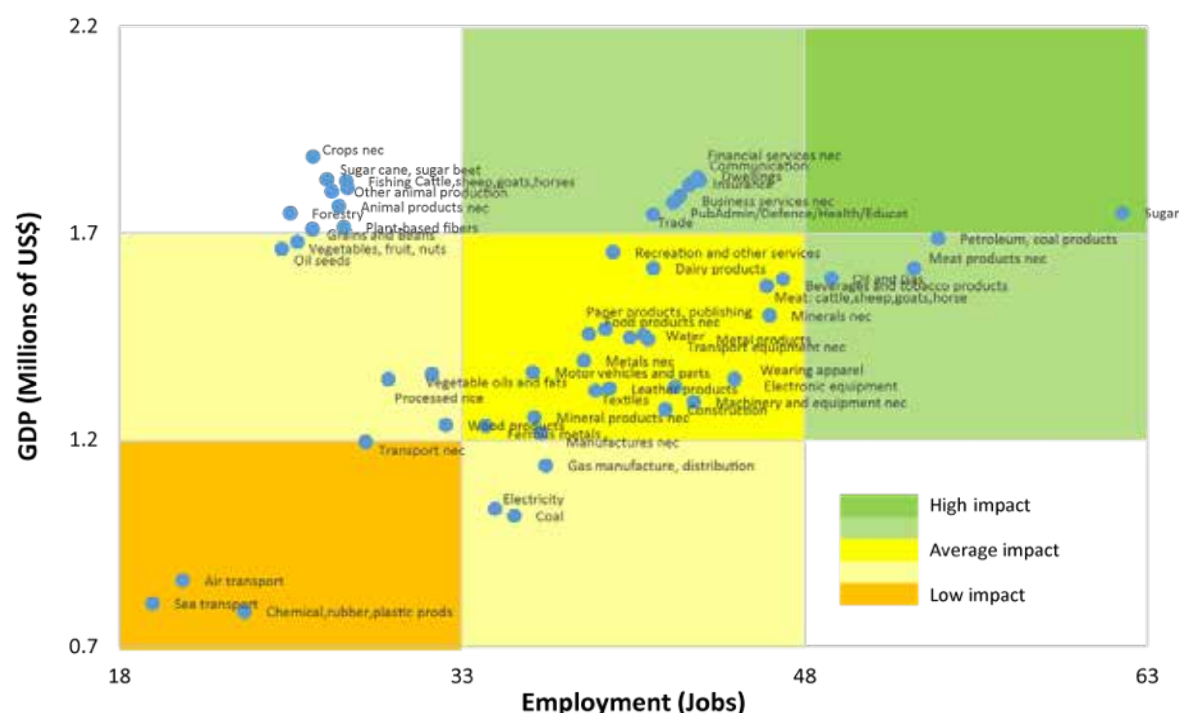


SECTORAL GDP AND EMPLOYMENT MULTIPLIERS IN GEORGIA

Private investment in Georgia will generate different impacts on the economy depending on the sector of investment. Figure E.1 shows sectoral multiplier effects in Georgia on gross domestic product (GDP) and employment in response to an increase in sector revenues by US\$1 million. These effects are computed

using a Social Accounting Matrix (SAM) multiplier approach,¹⁷ which assumes that increases in revenues, or output driven by positive shocks related to investments, or business model improvements across different industry sectors, generate both direct and indirect effects throughout the economy that add up

FIGURE E.1
Impact per US\$1 Million of Additional Revenue



Source: World Bank Group staff calculations based on data from the Global Trade Analysis Project and World Development Indicators.

to a cumulative impact. Direct effects pertain to the sectors directly impacted by these shocks, which will have an increase in output or revenue in response to investment. Indirect effects arise from the backward and forward production links in the economy, as well as consumption links that increase expenditure on goods and services in response to an increase in labor and capital income (through expanded employment and capital). However, it is important to note that the SAM multiplier approach is based on strong assumptions, including unlimited resources and supply responses in the domestic economy, fixed prices, no substitution effects, and a static, or unchanged structure of the economy with respect to technologies. Therefore, reported results are rounded and should be interpreted as an approximation that provides orders, or magnitude of expected economic impacts.

Despite weak backward links, agricultural sectors are among the industries with the highest GDP multipliers driven by large direct and induced effects. Figure E.1 shows that low-productivity sectors such as agriculture have high—around 1.8—GDP multipliers along with services sectors. The decomposition of multipliers into direct, indirect, and induced effects helps explain these patterns. The direct effects in these agricultural sectors have larger magnitudes compared with manufacturing sectors, due to a high ratio of value added-to-output (more than 50 percent) driven by the low cost of intermediate goods relative to revenue. The agricultural sector also has significant induced effects given its labor-intensive production structure: the labor share in value added accounts for about 80 percent in most agricultural subsectors with an exception of forestry (31 percent) and fishing (30 percent). Increased labor income of agricultural workers is primarily spent on food consumption or agricultural products, as most of the population of Georgia lives in rural areas with low-productive subsistence farming.¹⁸ Indeed, agriculture and food products account for more than 40 percent of households' total expenditure in Georgia, while the share of these sectors' value added constitutes around 20 percent of GDP.

Among other sectors with high GDP multipliers is the services sector (with few exceptions) that has large direct and induced effects. Large direct and induced effects in the services sector explain high GDP multipliers as in the case of agriculture. The services sector has high, on average 60 percent, GDP-to-output ratio due to low costs of intermediates relative to revenue, which inflates the direct impact

of investment. Induced effects have high magnitudes across the services sector, indicating the labor-intensive nature in these activities and a high share of household spending on domestically produced food products.

High-productivity and capital-intensive manufacturing subsectors generally have strong backward production links with other industries, but not in Georgia. GDP multipliers in most nonfood manufacturing industries lag behind the agriculture and services sectors. In these subsectors, the value-added to output ratio is relatively small explained by the high share of intermediate goods in the production, which reduces direct effects. At the same time, while indirect effects are higher than in other sectors given strong inter-industry links, they are reduced due to a high import dependency. It is important to note that industries with strong backward links and low (or high) import shares in the supply chain have high (or low) sectoral GDP multipliers. However, having an open economy is critical, as it promotes competition and improves competitiveness of domestic firms due to access to frontier technologies and know-how among other benefits. For example, imported machinery can increase competitiveness of other sectors that use machinery as intermediate goods or capital and increase export in the economy.

The services subsectors with high GDP multipliers and the manufacturing subsectors that have substantial job creation in the past exhibit higher employment multipliers compared with agriculture. The employment multipliers are computed using the sectoral GDP multipliers and historical employment elasticities for three broad sectors: agriculture, manufacturing, and services in Georgia. In particular, investment in any sector would generate GDP in each of the above mentioned three sectors and these GDPs are multiplied by their respective employment elasticities computed using average changes in the employment to GDP ratio over the period 2011–15. In fact, job creation in response to GDP changes was much higher in the manufacturing and services sectors compared with agriculture. High GDP multipliers combined with large number of created jobs lead to high employment multipliers in the services sector. Despite low GDP multipliers, the manufacturing sector has higher employment multipliers due to large job elasticities. Similarly, negligible job creation in agriculture compared with other sectors explains low employment multipliers.

KEY MACROECONOMIC INDICATORS, AT A GLANCE

TABLE F.1

Impact per US\$ 1 Million of Additional Revenue

	2013	2014	2015	2016e	2017p	2018p	2019p
National Accounts	(% change, unless otherwise indicated)						
GDP nominal (GEL, billions)	26.8	29.2	31.8	34.0	38.0	41.3	44.6
GDP nominal (US\$, billions)	16.1	16.5	14.0	14.4	15.2	15.9	16.4
Real GDP growth	3.4	4.6	2.9	2.8	4.8	4.5	4.7
Consumer price index (period average)	-0.5	3.1	4.0	2.1	6.7	4.0	3.0
GDP deflator	-0.8	3.8	5.9	3.2	6.6	4.0	3.0
GDP per capita (US\$, thousands)	3.6	3.7	3.8	3.9	4.0	4.3	4.4
Gross investment (% of GDP)	24.8	29.8	32.1	32.7	32.4	31.8	32.2
Gross national saving (% of GDP)	19.1	19.2	20.1	19.9	23.1	22.4	22.9
Unemployment rate (%)	14.6	12.4	12.0	11.8	—	—	—
General Government Operations	(% of GDP, unless otherwise indicated)						
Revenues and grants	27.5	28.0	28.1	28.4	28.8	28.7	28.6
Expenditure and net lending	30.1	31.0	31.9	32.3	32.6	32.5	32.1
Overall fiscal balance	-2.6	-2.9	-3.8	-3.9	-3.8	-3.5	-3.1
Total public debt	34.7	35.6	41.4	44.9	44.8	45.5	46.0
External Sector	(% of GDP, unless otherwise indicated)						
Current account balance	-5.8	-10.6	-12.0	-12.8	-9.3	-9.4	-9.2
Exports of goods and services	44.7	43.0	44.5	43.7	49.4	51.5	53.3
Imports of goods and services	57.6	60.6	62.3	59.3	60.2	62.6	64.8
Foreign direct investment (net)	5.1	8.1	9.0	9.3	9.2	9.0	9.1
Gross international reserves							
(Months imports of goods and services)	3.4	4.0	3.0	3.9	4.1	4.2	4.4
(US\$, million)	2,823	2,699	2,521	2,756	2,929	3,271	3,711
External debt (including inter-company loans)	81.8	83.0	106.6	112.3	113.1	114.6	115.1
Lari per US\$ (period average)	1.66	1.77	2.27	2.37	2.51	—	—

Source: Georgian authorities; and World Bank and IMF staff estimates and projections.

Note: GDP = gross domestic product; e = estimate; p = projection.

A DESCRIPTION OF THE LONG-TERM GROWTH MODEL

The Long-Term Growth Model (LTGM) is an Excel tool based on the celebrated Solow-Swan growth model, but adapted for growth analysis in developing countries.¹⁹ Investment, savings, and productivity are key growth drivers, but the model includes other factors important for developing and emerging countries, such as human capital, demographics, and labor market participation (especially for women). Recently, the baseline LTGM has been extended to allow for an analysis of the effects of growth (and inequality) on poverty, based on a log-normal approximation of the income distribution. Two important common results in the LTGM (both relevant for Georgia) are: First, investment-led growth is unsustainable in the long run, as the capital stock grows faster than output, which increases the capital-to-output ratio and reduces the effectiveness of investment for growth. Enhancing other growth drivers, such as total factor productivity, human capital and labor force participation, help to contain the capital-to-output ratio by boosting output, and hence make growth more sustainable. Second, high rates of investment need to be financed by either domestic or foreign savings. As foreign savings can be fickle, high rates of investment in the long run usually require high rates of domestic savings.

The economy consists of a single sector that produces gross domestic product (GDP) using physical

capital (K_t) and effective labor ($h_t L_t$). A_t denotes total factor productivity, which determines the aggregate efficiency of the economy.

$$(1) \quad Y_t = A_t K_t^{1-\beta} (h_t L_t)^\beta$$

where β is the aggregate labor share of income and effective labor is decomposed into human capital per worker (h_t) and the number of workers (L_t). The total number of workers can be written as:

$$(2) \quad L_t = \rho_t \omega_t N_t$$

where ρ_t is the participation rate, ω_t is the working age to total population ratio and N_t is the total population.

Physical capital next period (K_{t+1}) is formed by undepreciated capital $(1 - \delta)K_t$ and new investment I_t :

$$(3) \quad K_{t+1} = (1 - \delta) K_t + I_t$$

Investment is funded by S_t , either domestic savings or foreign savings via a current account deficit (CAD_t):

$$(4) \quad I_t/Y_t = S_t/Y_t + CAD_t/Y_t$$

One can further decompose changes in foreign savings into inbound foreign direct investment, and changes in total external debt (D_t):

$$(5) \quad \frac{I_t}{Y_t} = \frac{S_t}{Y_t} + \frac{FDI_t}{Y_t} + \frac{D_t}{Y_t} - \frac{D_{t-1}/Y_{t-1}}{(1+g_{y,t}^{pc})(1+g_{N,t})}$$

By combining these, the model can calculate growth resulting from an investment constraint (Model 1), or a savings constraint (Model 3), or it can calculate required investment to meet a growth target (Model 2). It also calculates changes in the poverty rate, as growth in GDP per capita shifts the income distribution to the right.

$$(6) \quad \begin{aligned} g_{y,t+1} &\approx g_{A,t+1} + \\ &\beta(g_{h,t+1} + g_{\omega,t+1} + g_{N,t+1} + g_{\rho,t+1}) + \\ &[\frac{1-\beta}{K_t/Y_t}] \frac{I_t}{Y_t} - (1-\beta)\delta \end{aligned}$$

Headline GDP growth ($g_{y,t+1}$) can be decomposed using a log-linear approximation into different

growth fundamentals (equation 6). Here $g_{x,t+1}$ is the growth rate of factor x from t to $t+1$. Equation 7 is the equivalent formulation for per capita GDP growth, $g_{y,t+1}^{pc} = g_{y,t+1} - g_{N,t+1}$, with the key difference being that population growth adds to headline GDP growth, but subtracts from GDP per capita growth.

$$(7) \quad \begin{aligned} g_{y,t+1}^{pc} &\approx g_{A,t+1} + \\ &\beta(g_{h,t+1} + g_{\omega,t+1} + g_{\rho,t+1}) + \\ &[\frac{1-\beta}{K_t/Y_t}] \frac{I_t}{Y_t} - (1-\beta)(\delta + g_{N,t+1}) \end{aligned}$$

$(1-\beta)/(K_t/Y_t)$ is the marginal product of capital (MPK), or the inverse of the marginal ICOR (mICOR), which determines the effectiveness of investment in boosting growth. An increase in (K_t/Y_t) , for example from excessive investment, will decrease the marginal product of capital (MPK) and increase the MICOR.

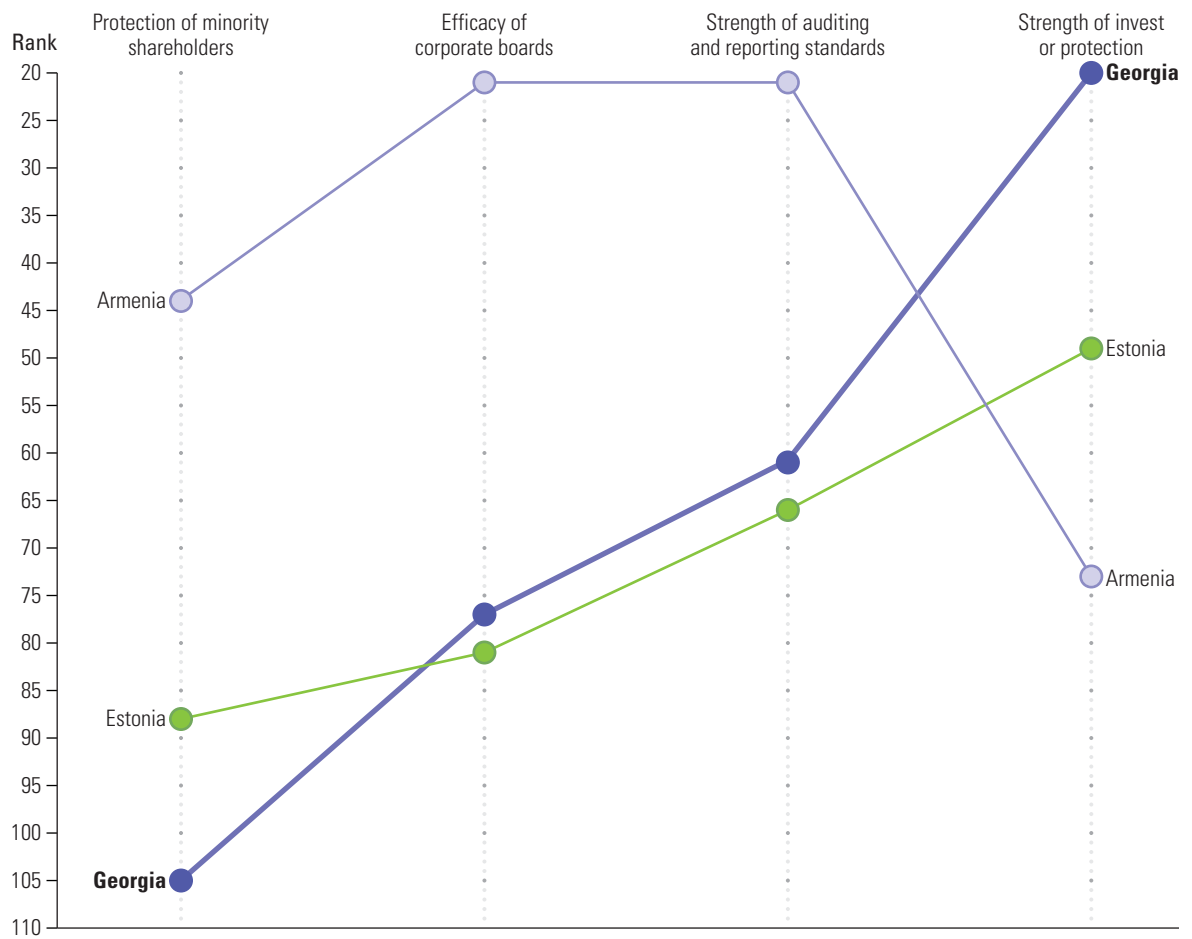
INVESTMENT CLIMATE DEFICIENCIES

- Land markets:** In 2017 *Doing Business*, Georgia is ranked 3rd on “ease of registering property” and 8th on “acquiring construction permits”. However, only a small proportion of land is registered and existing registries are outdated. Thus, access to land is limited de facto, which creates major barriers for firms, inhibits access to finance in rural areas, and the ability of local government to raise revenues.
- Framework for firm exit and restructuring:** Georgia ranks 106th on “resolving insolvency”. In Georgia, insolvency is defined as the inability of the debtor to pay its debts as they come due.²⁰ Therefore, it is possible that a viable business with cash flow problems may be pronounced insolvent and forced into bankruptcy. Incentives are missing for the financial intermediaries to provide post-petition financing. It is difficult for a creditor to initiate insolvency proceedings, which dampens the confidence that creditors have in loan recovery. There are other issues related to management and disposal of assets, the priority rights of the creditors, and restructuring proceedings.
- Investor protection:** The Global Competitiveness Index ranks Georgia 20th on “strength of investor protection”. However, in overall property rights protection is ranked 54th. Investors are facing risks related to regulatory uncertainty, adverse and/or frequent regulatory changes, breach of contract and transfer and convertibility restrictions. The new investment law, which is being developed, will include provisions to strengthen investor guarantees and protections²¹ in line with international standards. Georgia’s Business Ombudsman’s Office will need to be strengthened to better implement investor protections and manage critical investor grievances.
- Corporate governance.** Corporate governance challenges include inadequate corporate transparency related to information disclosure about financials and ownership structure, inefficient corporate boards and weak protection of minority shareholders (see figure H.1). While the corporate governance related provisions are stipulated in the legislation, they only apply to publicly traded companies, which are few in Georgia. A voluntary corporate governance code for banks is in place, but not widely followed. There is no corporate governance code for real sector companies. Recently, the government has made important amendments in the legislation, such as barring appointments of executives as Board Chairman or member of audit committee of the Board. These will help to increase the independence of corporate boards and enhance the protection of minority shareholders. However, these efforts remain fragmented and insufficient.

FIGURE H.1

Global Competitiveness Index

Corporate governance rank, 2016

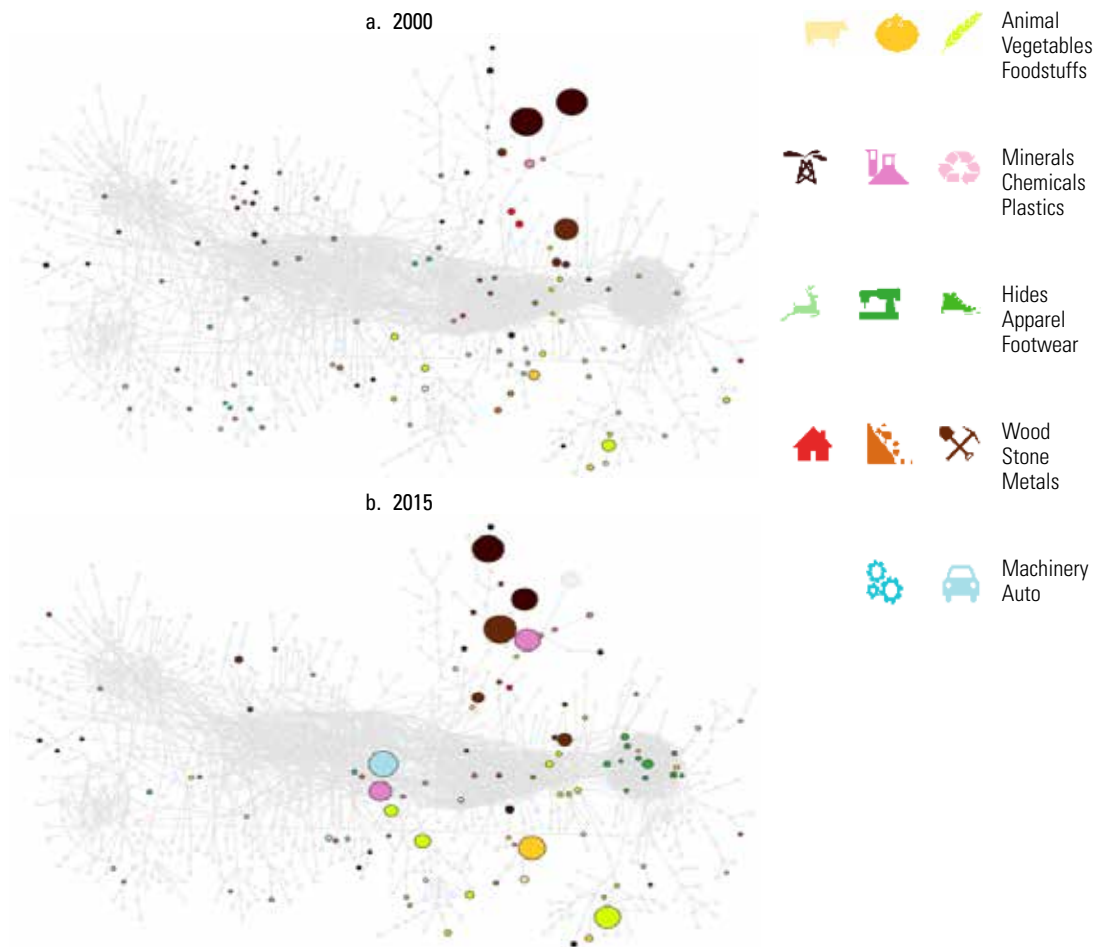


Source: World Economic Forum.

GEORGIA PRODUCT SPACE OF COMPETITIVELY EXPORTED PRODUCTS

FIGURE I.1

Georgia Product Space of Competitively Exported Products, 2000 and 2015



Source: Atlas of economic complexity, <http://atlas.cid.harvard.edu>.

Note: The size of the bubble is proportional to the share in total exports

Notes

1. MOA (2014).
2. The average area of land operated by farms is 1.4 hectares, with majority of them operating plots of less than 1 hectare.
3. The first phase (1992–98) of land privatization transferred 60 percent of arable land to about 1 million households, and the second phase (2005 onwards) and the Agro100 program (2007) privatized larger plots over 50 hectares.
4. Arezki, Deininger, and Selod (2012).
5. A subsidiary of the major global organic baby food group (HiPP), which entered Georgia's apple processing market in 2006, exited in 2014 as the company was not able to source enough raw material.
6. Mechanizatori LLC Rapid Assessment Report, IFC Public-Private Partnership Transaction Advisory, 2015.
7. A 6-to-10-day forecast costs GEL 30, a sector-specific 24-hour updates are GEL 500.
8. Georgian National Tourism Administration and National Statistics Agency (2017).
9. According to the World Travel and Tourism Council (2015), the indirect contribution is measured by the GDP and jobs supported by the spending of those who directly and indirectly employed by the travel and tourism sector.
10. Georgian Ministry of Internal Affairs (2017).
11. GNTA (2017)
12. IBRD (2016).
13. IBRD (2016).
14. Estimated at conservative price of US\$0.6 per kilowatt hour.
15. It would be interesting to look at the role of Georgia's tourism sector in global value chains. However, data availability constrained that analysis.
16. Firms also mentioned that in cut-make-trim segments, where margins are tight, exchange rate volatility appears to be an obstacle.
17. The main database for this model is the Global Trade Analysis Project version 9 <https://www.gtap.agecon.purdue.edu/databases/v9/> for estimating the employment multiplier, employment, and GDP database is taken from the World Bank's WDI database: <http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators>.
18. Kinkladze (2015).
19. See Pennings (2017) for a detailed model description. Further information about the tool is available from the authors, or on the MFM online tools intranet site. The LTGM builds on earlier work by Hevia and Loayza (2012).
20. Kuriakose (2013).
21. That is, guarantees of nondiscrimination, protection against expropriation, access to international dispute resolution mechanisms, and so on.

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